16

THE PRIVATIZATION EXPERIENCE: STRATEGIES AND IMPLICATIONS FOR SMALL BUSINESS DEVELOPMENT

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, APRIL 14, 1994

Printed for the use of the Committee on Small Business

Serial No. 103–75

U.S. GOVERNMENT PRINTING OFFICE

78–333 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046376-9

16

THE PRIVATIZATION EXPERIENCE: STRATEGIES AND IMPLICATIONS FOR SMALL BUSINESS DEVELOPMENT

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, APRIL 14, 1994

Printed for the use of the Committee on Small Business

Serial No. 103–75

U.S. GOVERNMENT PRINTING OFFICE

78–333 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046376-9

COMMITTEE ON SMALL BUSINESS

JOHN J. LAFALCE, New York, *Chairman*

NEAL SMITH, Iowa
IKE SKELTON, Missouri
ROMANO L. MAZZOLI, Kentucky
RON WYDEN, Oregon
NORMAN SISISKY, Virginia
JOHN CONYERS, JR., Michigan
JAMES H. BILBRAY, Nevada
KWEISI MFUME, Maryland
FLOYD H. FLAKE, New York
BILL SARPALIUS, Texas
GLENN POSHARD, Illinois
EVA M. CLAYTON, North Carolina
MARTIN T. MEEHAN, Massachusetts
PAT DANNER, Missouri
TED STRICKLAND, Ohio
NYDIA M. VELAZQUEZ, New York
CLEO FIELDS, Louisiana
MARJORIE MARGOLIES-MEZVINSKY, Pennsylvania
WALTER R. TUCKER III, California
RON KLINK, Pennsylvania
LUCILLE ROYBAL-ALLARD, California
EARL F. HILLIARD, Alabama
H. MARTIN LANCASTER, North Carolina
THOMAS H. ANDREWS, Maine
MAXINE WATERS, California
BENNIE G. THOMPSON, Mississippi

JAN MEYERS, Kansas
LARRY COMBEST, Texas
RICHARD H. BAKER, Louisiana
JOEL HEFLEY, Colorado
RONALD K. MACHTLEY, Rhode Island
JIM RAMSTAD, Minnesota
SAM JOHNSON, Texas
WILLIAM H. ZELIFF, JR., New Hampshire
MICHAEL A. "MAC" COLLINS, Georgia
SCOTT McINNIS, Colorado
MICHAEL HUFFINGTON, California
JAMES M. TALENT, Missouri
JOE KNOLLENBERG, Michigan
JAY DICKEY, Arkansas
JAY KIM, California
DONALD A. MANZULLO, Illinois
PETER G. TORKILDSEN, Massachusetts
ROB PORTMAN, Ohio

JEANNE M. ROSLANOWICK, *Staff Director*
JENIFER LOONS, *Minority Staff Director*

CONTENTS

THE PRIVATIZATION EXPERIENCE: STRATEGIES AND IMPLICATIONS FOR SMALL BUSINESS DEVELOPMENT

THURSDAY, APRIL 14, 1994

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m. room 2359–A, Rayburn House Office Building, Hon. John J. LaFalce, (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order. We are convening this morning to examine the issue of privatization. I happen to think that this is an extremely important issue. Privatization is a phenomenon that has been taking place over the past 8 years at an accelerating pace. I think that it is important that it does take place. But by the same token, I think that the way in which it takes place is at least equally as important.

It is important because it can help foster and develop an entrepreneurial class. I think that it is important, too, because it can more equitably distribute the existing wealth of society, and most importantly the potential wealth of society. Or it can inequitably concentrate that existing and potential wealth too.

I think that the manner of the privatization will have profound societal impacts. I do not believe that policymakers have given adequate attention, sometimes any attention, to this very, very important issue. I intend to change that. This is the first step in that. You gentlemen are helping in this embryonic effort. Having said that, I will read the statement that has been prepared.

It is imperative that we achieve a better understanding of the policy implications of this important means of economic transformation. Privatization carries with it the hopes of the emerging democracies, for whom it is the primary vehicle for creating market economies under a rule of law, and facilitating economic growth and development.

If accomplished successfully, privatization can legitimately be expected to increase economic efficiency, and provide broad based benefits to a country's citizens. However, if poorly implemented, privatization may only serve to channel resources to the same or different powerful elite groups. The issue this committee meets to consider is whether privatization in practice lives up to its promise.

The worldwide push for privatization in the past decade responds to both ideological and economic changes. Governments once committed to State ownership as a matter of ideology or to State cre-

ated enterprise as the quickest path to modernization now see privatization and expanded private markets as the best means to increase competition, enhance efficiency, and meet urgent infrastructure and development needs.

Numerous Asian and Latin American countries have made privatization a central feature of broader market-oriented reforms and democratization efforts, while reforms in Central and East European nations and the republics of the former Soviet Union are virtually synonymous with privatization.

Much of the hope surrounding privatization is based on the encouragement and support for small business that it can provide. Proponents herald privatization as a means for small business entrepreneurs in particular to create their own economic opportunities and grab a piece of the action, and in the process spur general development. The Enterprise Funds for Poland and Hungary were one manifestation of this approach.

Yet, however well intentioned, the privatization process has not always resulted in equitable opportunities for citizens and businesses who wish to participate. Instead we have often seen a "patron" or "nomenklatura" privatization, which allows an elite with influence and power to control the outcome and rewards of privatization.

In Mexico, the Indian uprising in the southern State of Chiapas is an example of negative impacts of this phenomena. Incidentally, this committee had hearings on the conditions in Chiapas in September 1993. We had the Executive Director of the Human Rights Commission of Chiapas testify.

These conditions remind us that however significant a country's economic reforms may appear, its success depends ultimately on significant improvements in equity. In this case, Mexico's removal of constitutional protections against privatization of communal farmlands was one of the sparks that lit the fire of political reform nationwide. This morning we will hear more details regarding the consequences of Mexico's privatization strategies from our witnesses.

A world away from rural Chiapas, officials of the Russian Republic are also engaged in massive privatization of State-owned properties. Thousands of small businesses have been sold for cash in public auctions. A system of private vouchers has been created to distribute ownership of medium and large scale enterprises throughout the population. Privatization of the bulk of Russia's material wealth has set off a scramble for available assets in which corrupt, criminal and even violent methods are becoming commonplace.

In this environment, the persons who appear to have been benefited most from privatization are the former elite of the communist system, the nomenklatura of high-level economic managers and former party officials with access to information, political contacts, and foreign currency. While even this privatization may be preferable to continued State ownership, surely we must strive to do better.

Countries as diverse as Chile, Malaysia, and Poland have put up for sale their airline systems, trading companies, banks, transportation systems, telephone services, and ports and power systems.

Throughout the world, privatization has raised hopes for improved efficiency, reduced bureaucracy, new foreign investment, and greater prosperity.

Many of these privatizations appear successful in dispersing ownership, enhancing efficiency, and increasing competition. But as some experiences suggest, other privatization efforts have failed to show that private ownership and operation are more efficient or respond better to consumers and workers.

The problem may be not that privatization per se is flawed, but that we have developed little basis to measure success. Too often, issues of social equity which should have been central may have been ignored.

This morning we have a distinguished panel of experts on privatization who will enlighten us on this process, and how it operates in various regions, and what the successes and failures have been thus far.

We will hear from Mr. James Waddell, executive director of the International Privatization Group at Price Waterhouse. Mr. Waddell's organization has recently developed a data base on privatization for the Agency for International Development.

Mr. Richard Barnet is the senior fellow and a founder of the Institute for Policy Studies. He is co-author of the well-known book, "Global Reach," that I read a long time ago. He has recently published a sequel, "Global Dreams."

Mr. Anders Aslund is director of the Stockholm Institute of Soviet and East European Economics, and currently he is a guest scholar at the Brookings Institution.

Mr. Chris Whalen returns to our committee bringing his experience in Latin America, and a particular focus on Mexico and Chile.

Dr. Lynn Nelson is a professor of sociology at the Virginia Commonwealth University. He spent half of the past 3 years in Russia. He recently published a study on his research there entitled, "Property to the People."

Finally, Mr. Daniel Singer, of counsel with Fried, Frank, Harris, Shriver and Jacobson, will provide the legal perspective. He is a specialist for the Central and East European Law Initiative of the American Bar Association, and has traveled to Poland, and will lend his legal expertise to the privatization effort.

I really believe that we have an outstanding panel. I doubt that we have had such experts on the privatization issue gathered at one time before on one panel, certainly not before Congress. I do not even know if the Congress ever had one hearing on this subject. So, I am looking forward to today's hearing tremendously.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LaFalce. Before we begin, I wonder if any others have any opening statements.

Mrs. Meyers, do you have any statement?

Mrs. Meyers. Thank you, Mr. Chairman.

I do believe that the privatization process, the transfer of productive assets from the public to the private sector, presents some of the most challenging issues for U.S. foreign and economic policy at this time. I also believe that the opportunities for small businesses, both domestic and foreign, which will flow from many of the ongoing privatization efforts, are limitless.

Successful small businesses are rarely found in controlled markets or centrally planned economies. In fact, the entire concept of Government ownership or control is an anathema to our notions of free enterprise. Although there may well be times when the transformation process to a market economy is painful, and it certainly is being in a number of countries throughout the world, I am sure that everyone here will agree that the end result of a strong private sector will benefit all in the long run.

This is particularly true for smaller enterprises. I thank today's distinguished panel of witnesses for taking the time to report on some of the ongoing privatization efforts throughout the world. I look forward to future hearings where we might be able to hear from small businesses that are beginning to benefit from these changes.

Thank you for holding this hearing, Mr. Chairman. I am also on the Foreign Affairs Committee. We do talk about this a great deal, and it is of tremendous interest to me, and of tremendous import.

Chairman LAFALCE. Thank you very much.

Mr. Flake.

Mr. FLAKE. Thank you very much. Good morning, Mr. Chairman.

Let me begin by commending you for the hearing. Because I am convinced that our future, and the future of many nations, is dependent upon our ability to find sources outside of Government to participate in fully developing or redeveloping many of the cities, and many of the countries and States, that currently find themselves in difficulty.

For years, we have talked about various forms of social legislation. I think that it is unfortunate that there has not been a full discussion given in the past to the whole question of privatization. We understand that there are forces that react whenever the term privatization is used, with the feeling that indeed we are cutting either unions or others out of the process of participation.

The reality is that as we look at the limited Government funding that is available — whether it is at city, State, or Federal levels, and cutbacks in all of those budgets — there is an urgency that we find other ways to make our country viable, and to make other countries viable. I think that privatization at least ought to be explored as a possibility.

So I commend you for the hearing. I ask unanimous consent to have my statement read into the record, as well as any questions that I might like to submit to the participants, since I will be going to a banking hearing following this. Thank you.

Chairman LAFALCE. Thank you very much.

Mr. Hilliard.

Mr. HILLIARD. Thank you very much, Mr. Chairman.

Mr. Chairman, I just want to reiterate and join my colleagues in commending you for holding this hearing at this time. It is extremely important that each country involved will have full participation. I see privatization as a method of achieving that.

As Governments strive to make their countries better, the more participation they have, Mr. Chairman, from all levels of society increases the likelihood that democracy will prevail, and that it will be successful. So, I am very happy that you have timely brought this subject matter to the table, Mr. Chairman, and thanks.

Chairman LaFalce. Let us continue with our first witness, and we will just go down the table. It will be Mr. Waddell from Price Waterhouse. I understand that you know everything that there is to know about the subject, Mr. Waddell. So, please proceed.

TESTIMONY OF JAMES A. WADDELL, PARTNER, OFFICE OF GOVERNMENT SERVICES, AND EXECUTIVE DIRECTOR OF INTERNATIONAL PRIVATIZATION GROUP, PRICE WATERHOUSE

Mr. Waddell. I would be happy to help to the extent I can.

Thank you, Mr. Chairman. I am Jim Waddell. I am a partner in Price Waterhouse's Office of Government Services. I also hold the position as the executive director of the International Privatization Group within Price Waterhouse.

This group has conducted privatization programs in over 40 countries in all regions of the world, and has participated in transactions using various privatization techniques. By far, the largest funding source for our activities has been the U.S. Agency for International Development. My time as the executive director of the International Privatization Group is fully dedicated to a U.S. AID finance project called Privatization and Development.

Chairman LaFalce. Do you have a prepared statement that you are reading from?

Mr. Waddell. I do, yes.

Chairman LaFalce. Have you shared that with our staff?

Mr. Waddell. No.

Chairman LaFalce. That would be a good idea. Thanks. Please continue.

Mr. Waddell. I have been asked to contribute to the hearing this morning by reviewing the major approaches to privatization that have been used, the benefits and drawbacks associated with each approach, the conditions under which different approaches have been successful, future trends in privatization programs, and generally commenting on whether the approaches that have been taken lead to equitable outcomes in the privatization process.

I think that the right way to start to address this question is by first stepping back and asking what is privatization. Privatization is generally the process of transferring productive operations and assets from the public sector to the private sector.

Broadly defined in this fashion, privatization is much more than selling an enterprise of the highest bidder, as it includes contracting out, leasing, private sector financing of infrastructure projects, liquidation, mass privatization, and many other mechanisms.

My testimony will argue that there is no single best approach to privatization. The appropriate privatization path depends on the goals that the Government is seeking to attain, the individual circumstances facing the enterprise, and the economic and political context of the country.

It should be noted first that privatization is just as much a political process as it is a commercial and economic process. Privatization changes the distribution of power within a society, as it diminishes control of the economy by the State and by Government appointed managers.

Workers also often feel threatened by the potential changes inherent in privatization, although employees in fact, frequently benefit from the process. As a result, public support is a major consideration in any privatization program. Many of the choices made in designing and implementing transactions reflect the need for such support.

Two consequences flow from this factor. First, the choices of approaches are sometimes altered due to "political considerations," meaning that equity must be promoted in the privatization strategy. Two, program implementation must be objective and fair to avoid adverse publicity.

We have generally cited several different goals for privatization. Each country has slightly different goals. Those goals obviously are reflected in the programs that result. The goals generally follow along two dimensions. First, broad social or macroeconomic goals. Second, enterprise-specific or microeconomic goals. The general macroeconomic goals are numerous.

Fundamentally, privatization is advocated as a means to reduce the Government's role in the economy, partly as a philosophical matter, as was done in the United Kingdom, but principally because Governments have performed badly in that role. Many countries can attribute substantial portions of their external debt to liabilities of State owned enterprises, and significant portions of Government budgets are devoted to paying subsidies or otherwise assisting loss-making State owned enterprises.

Governments' objectives in these situations is often simply to extricate themselves from these financial commitments, and focus scarce resources instead on education, infrastructure, and social welfare.

The second macroeconomic goal of privatization is to promote the development of the private sector by leveling the playing field, and ending subsidized competition from State-owned enterprises. There is a danger that emerging private businesses face unfair competition from State enterprises that have access to credit and other inputs at below-market rates, and better access to Government distribution channels. In order to give the private sector a fair opportunity to compete and thrive, State-owned enterprises are privatized.

The third goal of privatization is to obtain the sales proceeds and use them to finance shortfalls in the Government's budget, or retire some of the public sector debt. While it is widely recognized that focusing on sales proceeds may be shortsighted and ignore other important outcomes of privatization, it is a fact that many Governments are strongly influenced by the availability of funds from privatization.

A fourth general goal is to broaden share ownership, so that the public has mechanisms for saving and participating in the economies of their countries.

The microeconomic goals of privatization focus mostly on the potential improvements that private sector operators will bring to an enterprise to improve its performance and increase its chances of survival. These goals recognize the need to improve enterprise efficiency by introducing new technology and financing, improving the quality of products, enhancing marketing, providing information

systems, and generally improving the management of the enterprise.

Obviously, successful changes of this nature when applied to a number of individual enterprises will have significant macroeconomic implications as well.

Mr. Chairman, I would like to spend most of my time this morning commenting generally on the different types of privatizations that have been used around the world, and responding to the questions from the committee concerning the success or failure of the general privatization techniques that have been adopted.

There are several different techniques, and many of them are widely used around the world today. The first I would note is the auctioning of small businesses. Generally, when we are talking of a very small business, a sole proprietorship or a small partnership, shops on the street, laundromats, and so forth, the most effective way to privatize those enterprises is simply to auction them to the highest bidder.

That process can be done very quickly, and there is little chance of having difficulty in evaluating the bids simply because there is only one criteria, price, that will determine the outcome of the bid.

Auctions, however, are generally not appropriate for larger enterprises, because the bids will not be as readily comparable. For larger enterprises, there are many other goals at stake. As a result, we often seek to evaluate the quality of the new ownership group, and determine what technology it will bring, how well financed is it, what investments will it commit to making, where will it market its products, will it close the business, and so forth.

A second common privatization method is to conduct a trade sale, and sell particularly larger enterprises to strategic investors. This type of privatization is conducted on a case by case basis, by soliciting technically and financially capable investors to acquire the enterprise.

In soliciting the investors, the seller conducts a thorough review of the business, and prepares material describing the business, and its equipment, work force, financial conditions, markets, and prospects.

This information is circulated to a group of candidate investors that have expressed initial interest in the business. These investors then submit bids outlining the terms under which they would purchase shares of the enterprise.

The offers will discuss the percentage of shares to be purchased, what debts will be assumed, future investment plans, and the financing associated with the expansion, any anticipated changes to the underlying business or the work force, actions required of the Government, and other significant factors.

Because bids received in this fashion are not readily comparable, the seller must prepare an evaluation of the enterprise and the bids received, analyze the strengths and weaknesses of the bidding groups, and then engage in a significant amount of negotiation with the highest ranked bidder. This process is often lengthy, as there are significant but difficult issues at stake.

Significant disadvantages of trade sales is that they take a long period of time to implement, and require substantial expenses to conduct. Because of the substantial amount of negotiation often in-

volved, they also have the aura of back room deals being conducted, and are susceptible to complaints from bidders that the decision process was unfair, particularly when the bids are structured very differently.

The third technique is initial public offerings. This approach was used widely in the United Kingdom during their well known privatization program. In an initial public offering, the shares of the enterprise are sold broadly to the public. A valuation is required in this process, in order to appropriately price the shares that are being offered. Because the public generally consists of relatively unsophisticated investors, there is a good deal of preparation, disclosure, and analysis that must be conducted before going through the IPO route.

The disadvantages of IPO's are that they do not bring new capital to the enterprise, and do not bring in new managerial talent or resources. As a result, IPO's are generally only used if the performance of existing management is satisfactory, and if there is an existing stock exchange to market the shares.

As a result, many times developing countries cannot take advantage of initial public offerings, although many of them will State it as a goal in order to broaden their capital markets.

The fourth technique is the use of joint ventures. This is a common form of privatization. It is as complete a form of privatization as other mechanisms. It implies that a private investor will add capital, or technology, or a patented process of some sort to an existing Government enterprise, and essentially become part of the ownership group along with the Government.

Because the Government does not totally disengage itself from the enterprise, there are many disadvantages to joint ventures as a form of privatization. Since the Government remains involved, it retains its liability for poor performance, and its obligation to help to finance the enterprise.

A further technique which has recently been developed and is quite commonly found now in the former Soviet Union and Central and Eastern Europe are mass privatization programs. I believe that these are one of the significant innovations in privatization techniques during the last few years.

In concept, mass privatization programs avoid the time and expense of case by case transactions, and involve the general public by distributing shares for free, or in exchange for specially created privatization vouchers. The mechanics of mass privatization programs are similar to IPO's, except that vouchers are used to purchase shares rather than using cash. As a result, significantly less analytical time is required, and disclosure requirements are greatly reduced.

The main virtue of the mass privatization program is that it is much more rapid than other forms of privatization, and it is much less costly.

To give you an indication of the calculation that was being made by the donor groups, as we were approaching the privatization of enterprises in Russia, it was widely quoted that the World Bank believed that it would cost about half a million dollars to privatize one enterprise using the case by case trade sale method. It was es-

timated that there were about 70,000 enterprises in Russia that needed to be privatized quickly.

You can see that at a cost of $35 billion that it was very unlikely that assistance would be found to accomplish the task in that fashion.

Also, trade sales generally take a long period of time. We have just completed a transaction in Poland that has taken over 2 years to complete, for a single transaction. So, if you are thinking about moving thousands and thousands of enterprises through the process, you really need to find a mechanism to short cut some of those disadvantages associated with trade sales.

There are disadvantages of mass privatization programs also, however. These lie principally in the diffusion of ownership across broad groups. That is we are talking the shares of the enterprises, and we are distributing them generally to the population. Second, management of the enterprise has a very large degree of control over the process itself in many countries.

It has been argued that because of these factors that subsequent restructuring of enterprises will be more difficult. Offsetting this argument to some degree, however, is the fact that potential investors, private sector foreign investors, can negotiate with a new ownership group, rather than negotiating with the Government, and can make investments that go into the enterprise directly in return for shares, rather than having their funds go into the State treasury. Both of these features are valuable features to investors.

Another technique that is becoming more widely used in privatization is for infrastructure projects, to develop what are called build-own-transfer or build-own-operate concessions, whereby a private sector group will finance, build, and operate say, a power station under contract to the Government. It will take all of the operating risks, and much of the financial risks, and provide superior performance in building and operating this power plant. They will get a return by selling the output of a power station to a Government utility.

These techniques also take a good deal of time to negotiate, because they are very elaborate contracts, and because a lot of money is at stake. We were involved in the negotiations in Pakistan concerning a power plant. It cost $1.8 billion, and it has taken 4 or 5 years to negotiate this.

But the Government has proven that it is incapable of constructing and operating power plants. As a result, this technique has been used to bring in the private sector.

The final technique that I want to mention this morning is liquidation. Liquidation is simply taking a State owned enterprise that has very limited prospects for survival, liquidating it, and selling its assets to the private sector. This is often done using auction techniques. Generally, the Government receives very little for liquidated enterprises. This technique is used generally as a last resort, and is applicable only in a limited set of circumstances.

Now there are several general features of privatization programs regardless of the technique that is chosen that I think are important for us to mention this morning.

The first is the need for speed in the process of privatization. I know that there are many criticisms both here and in developing

countries of the privatization process and some of the decisions that are made, that maybe things could have been done a little differently, and the performance of the program would have improved.

But I will tell you this morning that there is a very real tradeoff between making perfect decisions and the amount of time that it takes to implement a privatization program. There is a very dangerous period in the life of these enterprises when the Government has decided that they will be privatized until the time when an actual new ownership group has control.

During that period, enterprises are virtually controlled by management, and they have very little incentive to respect the rights and the investment of capital in the enterprise. It is during this period when I think asset stripping and other misfeasance is most dangerous. As a result, speed is absolutely critical to minimize the vacuum of ownership that is found in many enterprises, particularly in Eastern Europe and the former Soviet Union.

Second, the transparency of the privatization process has to be absolutely preserved and publicized. Any questionable ethical conduct has the potential to destroy the integrity of the process, and erode critical public support.

Finally, the privatization program must be implemented professionally. If it is not, the enterprises, investors, and the public could be discouraged from participating in the process.

My prepared statement then, Mr. Chairman, goes through a relatively long discussion of privatization developments around the world. I will just highlight a very few cases.

Chairman LaFalce. Let me just say that with six witnesses, it is imperative that each witness attempt to make his presentation in approximately 10 minutes or less. I did not make that statement before you started. I should have, so, that we can have a colloquy amongst the panelists, and with the Members of Congress. So, do try to summarize your country by country into at least geographic regions.

Mr. Waddell. I will do that. Latin America has had a lot of success very recently, primarily using case by case transactions, selling large enterprises, principally as trade sales and with some follow-on activity through public offerings. So, first, they would get a foreign investor to purchase a bank, a utility, and then following on that would sell some of the shares to the public at large.

Chile is an example of a program that is virtually complete. I think that there are many lessons to be taken from privatization in Latin America.

Turning to Asia, there has been a substantial amount of development in Asia as well. Much more of that has been done through stock exchanges, and through public offerings. Even China at this point is starting to do some public offerings. Asia has focused quite a bit also on infrastructure financing, and some of the build-own-operate and built-own-transfer techniques that I mentioned earlier. There are also some cases, Malaysia is an example, where privatization tends to be only partial to bring in the private sector for a small ownership interest, and keeping a lot of the control with the Government.

Africa has the reputation of being very slow in privatization. I think to a large extent that that is justified. There are a few coun-

tries, however, that have developed interesting privatization programs, and are starting to build some momentum in privatizing. These would include both Morocco and Zambia, as countries that have really started to accelerate the privatization process.

The case of Central, and Eastern Europe, and the former Soviet Union is much better known. There have been very successful small scale privatization programs in most of those countries. There has been some degree, although probably a disappointing amount, of trade sales, primarily due to the difficulties of operating in markets with political and macroeconomic instability.

The whole notion of mass privatization programs and the divestiture of thousands of enterprises in less than a year's time in Russia has also been an encouraging sign in that region.

Let me just conclude by saying that I think the United States' role in the worldwide movement toward privatization has been less of an example because our economy is substantially in the private sector to start with, and more as a promoter of privatization and more in providing assistance that is generally used to open the privatization process to allow for wider marketing of enterprises, and to accelerate the process in ways that probably would not have been possible without the assistance provided by the U.S. Government.

So with your advice, Mr. Chairman, I will end at this point and respond to any questions.

[Mr. Waddell's statement may be found in the appendix.]

Chairman LaFalce. Thank you.

I regret having to constrain you because each of you could have been a solo panelist unto yourself, and we could have spent hours and hours just talking with each and every one of you, but we cannot do that, and so we are going to have to short circuit it.

Our next witness is going to be Dr. Barnet, author of "Global Reach," and most recently "Global Dreams."

Dr. Barnet.

TESTIMONY OF RICHARD J. BARNET, AUTHOR

Mr. Barnet. Thank you very much, Mr. Chairman. I am very pleased to be here today and to respond to your request that I share some of the findings on the effects of globalization that my colleague and I have been studying over the past several years, and in that context, to talk primarily about privatization.

It is important in judging the effects of any particular privatization program, to see it in the larger context of the globalization of that economy; the prime issue is how a national economy is being integrated into the world economy.

I have just returned from a visit in Mexico where I had the opportunity to discuss the privatization program with journalists, sociologists, economists, and political figures. I believe that Mexico is an important example to study, primarily for how privatization should not be done.

All over the world, including our own country, the opening up of economies, which may have very substantial economic and political benefits, also have the effect in many cases of widening the gap between the beneficiaries of economic reform and those whose situation is worsened. We see this even in city blocks in our own county.

Neighborhoods where plants and headquarters of global companies and banks are located are prime beneficiaries of globalization. But a few blocks away in neighborhoods that once had substantial small business and local industry, you see the victims: The remains of enterprises that have gone to other places or other remnants of once vibrant economies that are left with little but memories of better times.

Mexico offers a good case study to offer some of the most serious problems associated with privatization. The history of Government's role in the economy is, I am sure, known to the Members. Since 1938, the Government has been deeply involved in the ownership of major economic assets. But the idea that the Government was the manager, the rector of the economy, became enshrined in the Mexican constitution.

In the 1970's, State intervention expanded dramatically in the belief that this would reinforce national sovereignty and economic independence, and that it would somehow generate the revenues that could be used to improve the standard of living of Mexico's large impoverished population.

So the high point of State ownership, 1982, the year that Lopez Portillo nationalized the banking industry, was a time when the State was running 1,155 firms. By this time inflation was rampant, the peso was overvalued, and other major economic problems were becoming more serious all at the same time.

Mexico's economic policy then shifted dramatically. By 1991, only 260 firms were still under Government control. The major problem in the way in which the Mexican privatization took place was that it promoted substantial concentration of capital. By and large, State firms were made available in most cases to Mexican entrepreneurs and financiers, who were in a position to buy the State enterprises. Very little effort was made to sell shares to the public, except after the basic control was established through private arrangements.

It is hardly surprising that billions of dollars in State assets have gone to supporters and cronies of the ruling party. That, unfortunately, is part of the culture of Mexico. The great majority of State enterprises were not disposed of under programs designed to spread ownership either to employees or to small investors. In many cases bargain basement prices were paid. One example — perhaps the most famous — is the telephone monopoly, where the Government arranged the issue of shares, dividing them between controlling and noncontrolling shares, such that a $3.9 billion company that earned well over a billion dollars a year was effectively purchased for $400 million.

Privatization has clearly enriched a small number of Mexican entrepreneurs at a time when the basic statistics on income distribution, on malnutrition, on public health in the country indicate a serious decline in the health and living standards of most Mexicans.

Now, to what extent can you blame the privatization program? The primary impact has been on employment; 400,000 jobs have been lost as a result of privatization. This has come about in part because the Government itself cut back payrolls — in many cases, excessive payrolls — to make the assets more attractive to private investors.

"The people love to buy when we have already managed the cleanup" is the way the finance minister put it last year.

According to a study published in 1988, about 53 percent of the State-owned firms were taken over by the Government because their former owners had gone bankrupt. Some of these same firms were sold back to some of the same owners after the Government had simply put them back in working order. But a much larger number of firms were simply closed and this, of course, further complicated the unemployment problem.

The sale of State companies brought more than $21 billion into the Mexican treasury. Almost all of it went to retire the national debt, and it made possible controlling inflation and cutting interest obligations and a number of benefits. But the sale of major national companies, that in some cases were run profitably, and others that conceivably could have been turned into profitable enterprises under proper management, undermined the Government's long-term revenue base. A very serious problem in Mexico is tax collection. There is a real question whether the Government will be able, despite recent reforms in the tax law, to recover sufficient tax revenues to make up for the loss in these assets.

As to the services, now being reduced by privatized firms, some are indeed showing improved service. AeroMexico is one example. But noticeable improvement in the banking sector has yet to occur, and the same goes for the telephone system.

The World Bank has cited the Mexican privatization program as a model, but the negative impacts are very clear. Encouraging competition, Mexican officials themselves admit, is not a high Government priority, nor has it been characteristic of Mexican business culture. Creating private monopolies in telecommunications, buses, trucks, sugar, lumber, appliance manufacturing, and other key sectors does not represent a promising solution to Mexico's problems.

Finally, I think privatization should be judged for what it is; just one critical component of a larger reform program. If one looks at the social statistics that I have referred to, especially the crime statistics in Mexico City where the incidence of crime rose from 40,000 in 1981 to over 71,000 in 1989, it is evident that widespread reform has been accompanied by serious increase in social and political instability. The armed rebellion is an even more dramatic example.

Mexico's prosperity is dependent on its prospects for long-term stability. The development choices now being made necessarily restrict the Government's traditional role in guiding the economy, a role which, to be sure was not always well carried out. But Mexico now faces the serious question of where the political and economic energy may be found in this new economy to deal with the massive social and economic problems of the vast numbers of people who are not participating in the benefits of privatization but are bearing the brunt of the negative consequences of the economic reform.

Finally, as to what the United States attitude would be, I believe that this is not an ideological question. Nor should it be treated as such. Whether privatization in troubled economies works depends on how it is done, but it also depends on the strength of the public sector. Not all public enterprises are inefficient. We see from a number of successful economies — Germany, Japan, and Korea among others — that there are a great range of relationships be-

tween Government and business that have had very positive effects on development.

Uncritical ideological support from the United States for privatization when Governments embarking on this course fail to address cultural social and equity problems is not a national interest. This is especially true where privatization exacerbates economic and social problems, and even more so when the country concerned is on our own border.

Thank you, Mr. Chairman.

[Mr. Barnet's statement may be found in the appendix.]

Chairman LAFALCE. Thank you, Dr. Barnet.

Our next witness is Dr. Anders Aslund. Dr. Aslund is the Director of the Stockholm Institute for Soviet-East European Economics. Presently, he is the guest scholar at the Brookings Institute.

Dr. Aslund.

TESTIMONY OF ANDERS ASLUND, DIRECTOR, STOCKHOLM INSTITUTE FOR SOVIET-EAST EUROPEAN ECONOMICS

Mr. ASLUND. Yes, thank you, Mr. Chairman.

Well, I would like to discuss with you the more successful part of Russian transformation, namely, the privatization. But perhaps before this I should say that I have a statement that I faxed in yesterday, but I have only one copy. I can give it to you afterwards.

Chairman LAFALCE. Fine.

Would you bring the microphone a bit closer to you?

Mr. ASLUND. Yes. I should also say that I worked as an economic adviser to the Russian Government from November 1991, when the reform Government came in, until January 1994, so I have seen quite a bit of this close-hand, even if I did not work much directly with privatization.

Generally, we can see now that privatization has developed very differently in different former communist countries. Well, first, if we take small-scale privatization of shops and workshops, kiosks, bars, and restaurants, that goes pretty easy. They are simply sold off in one way or the other, preferably auctioned off at the local level.

But if we look up on large enterprises, the success has been very different in different countries. First, we had Hungary that insisted on sales of all enterprises.

Chairman LAFALCE. First we had what?

Mr. ASLUND. Hungary.

Chairman LAFALCE. Oh, Hungary.

Mr. ASLUND. That insisted on sales of all enterprises. The result was that it did not go all that fast, and they had a lot of enterprises that no one wanted to buy. A lot of foreign enterprises invested in Hungary, which created an increasing reaction against foreign enterprises.

Poland had the most sophisticated discussion of privatization, but as a result a very complex legislation on privatization, making it possible for anyone to veto the privatization. In the end, only about 300,000 jobs had been transferred to the private sector in large- and medium-sized enterprises. Strangely, in Poland large-scale privatization has so far been a big failure in an otherwise

very successful economy where more than 60 percent of the labor force now work in the private sector, but for other reasons.

The Czech republic stands out as the most successful country in terms of privatization in Eastern Europe, thanks to a mass privatization program for the whole population. About 1,000 big- and medium-sized enterprises have been privatized.

Russia follows upon the experience from Poland and Czechoslovakia, essentially learning not to do the mistakes of Poland, but trying to do what has been successful in Czechoslovakia, at the same time noticing that there are peculiarities in Russia. The country is bigger. Therefore, you need more decentralization. The administration is much more corrupt. Therefore, you need to simplify.

I would argue that Russia has had an extraordinary success in its privatization. More than 50 percent of Russian labor force now work in the private sector. We are discussing something like 15,000 large- and medium-sized enterprises that have actually been privatized. The definitions here may vary, which is the reason why figures are different.

How was this possible? Well, it was possible because of political astuteness and it was very well organized in spite of an otherwise pretty messy economy, not to mention the politics and the administration.

What I want to discuss with you here is ideas and principles behind this privatization. I should mention that this is part of a book I am currently writing on how Russia became a market economy.

First, there was a urge for great speed of the privatization. Why? Well, Mr. Waddell here mentioned the importance of speed in privatization, and there was a clear understanding from top down that what is not privatized will be stolen by the old nomenklatura.

This also meant that people did realize that public property is not very public. In fact, there are various stakeholders in public property. Whether you respect them or not, there are some kind of property rights, and they have to be dealt with. Otherwise, you cannot get anywhere.

There was a strong idea that there should be broad ownership. It should be an ownership structure that supported a well-functioning market economy, but at the same time the reality of property rights was accepted. There was no sense of an exact justice that should be achieved because it was clearly not possible. It was more important to carry privatization out.

One problem that was sorted out early was restitution. Russia has no restitution to former owners, which is rather natural since they ceased so long ago.

In order to get the privatization going, it was necessary to make the enterprises legal entities, that is, transform the big enterprises to joint stock companies. Then the shares were divided into two groups early on. A part were given to the State, which meant the State property committee. Part of them were given to the workers. It was deemed very important to give the workers, meaning both managers and workers, a substantial stake in the enterprises so that they watched the property in order to avoid asset stripping, raiding and general irresponsibility, and also to co-opt the workers so that the workers and the managers would go along with the privatization.

State revenues were initially considered rather important for the stabilization efforts. Gradually they have lost importance in the debates and are not really cared about apart from local authorities.

Apart from giving away shares to workers and managers, there has also been an attempt to give away ownership rights to the population at large. This means that privatization vouchers, that have been distributed to all citizens who care to pick them up at the local savings banks, which 97 percent did.

Since workers and managers were given their shares first, they have effectively been given priority over the population at large, so we can see that privatization vouchers have not brought a high value.

Foreign investment was initially mentioned as important. In effect, it has been neglected and played down gradually, and I think rightly so.

First, the conditions have not been conducive to large foreign investment.

Second, it could arouse the public dislike of privatization, and this is an additional feature of Russian privatization program. Any controversy has been avoided if it is not necessary to deal with it. Leave the problems until later. Do what is doable first. Leave energy, for example, until later, natural resources, whatever that is considered a national treasure, and therefore do not give foreigners any particular advantage. That will create trouble.

All along market creation has been considered very important. Market prices, preferably established through auctions, have been preferred. Transparency has been a strong ambition. There has been a strong attempt to develop capital markets by making it permissible to sell and buy the privatization vouchers. There has been an attempt to avoid monopoly, but much as we heard in the Mexican case, it has proved very difficult. It is difficult to break up big enterprises, and the preference has been to privatize rather than to leave a lot of monopolies in State hands.

The general excessive concentration of ownership, both within the individual enterprises and generally has been avoided if possible.

The administration of the privatization program has been quite amazing in this general mess that Russian State administration has been during recent years. It has been important that one minister has been in charge of privatization, and a minister with a strong standing within the cabinet. On top of it, Anatoii Chubais has been a long-service minister by Russian standards, sitting since November 1991, when the privatization program really started.

It is also very important that President Yeltsin has been fully supportive and strongly involved in the privatization program.

There has been a number of privatization programs. While there was no overall reform program to begin with, there was a privatization program providing clear guidelines, and these programs have been renewed annually with the necessary adjustments.

While the parliament came out against most other reforms, the privatization program was actually adopted by the parliament in June 1992. A large regional privatization organization has been developed, and I think it is very important that the privatization or-

ganization as a whole has been new, newly developed, avoiding much of the problems of the old communist administration.

Curiously, plan targets were set for privatization initially, but this was a way of getting the not very reformed officials working for privatization. They wanted to know what to do. Give us a plan target, they said, and the young privatizers did so. The privatization programs have been decentralized, primarily to the enterprises, and the enterprises were partly ordered, partly enticed to present a privatization program.

It has been quite important no one could veto privatization, apart from the minister of the privatization; unlike in Poland.

The legal framework has all along been a problem since private property requires a lot of law, and there is very little functioning law in Russia. The solution has been to make it as simply as possible, to avoid gridlock in courts, and also necessary tolerance against transgressions to avoid cases that would block the whole privatization program, because then the effect would be that State property would be stolen on a greater scale than what you manage to save through one particular court case.

In this process a very substantial Western technical assistance has been used, and I would argue that this belongs to the best support the West has provided to the transition process in the former communist bloc. One good reflection of this is that you do not hear much of it, because there is not much controversy within Russia, and it is very well administered. You can see from the high speed of privatization that it does help.

Also the Russians have a policy which the Western assistance can help. I should mention that the U.S. aid has given very substantial support and it has done a lot of good.

Why do I argue that the Russian privatization has been a success? First of all, it has been a large transfer. There are very many owners now in Russia, and the property rights are individual. Admittedly the legal system is too weak. You cannot defend much, but the property rights are there to be defended. As we see now when the stabilization at long last is starting, managers are being ejected because of poor performance. Previously that was not the case simply because the enterprises were afloat in money because of a very loose monetary policy. But much of the actual performance of enterprises remains to be seen.

Thank you.

[Mr. Aslund's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Dr. Aslund.

I think shortly, when we hear from Dr. Nelson, who might have a slightly different perspective; you might have a rejoinder of issue there.

As we listened to your comments, all of you, I think it is very important for all of us up here to realize the profound differences in the problems of potential of privatization in different countries. So, it is difficult to compare a Chile to a Soviet Union, or excuse me, Russia; profoundly different situations.

We will next hear from Mr. Chris Whalen. Mr. Whalen has appeared before the committee on a number of occasions. He is the head of the Whalen Company.

We are delighted to have you again, Mr. Whalen.

TESTIMONY OF CHRISTOPHER WHALEN, DIRECTOR, THE WHALEN CO.

Mr. WHALEN. Thank you, Mr. Chairman.

You have asked me today to compare the privatization experiences in Chile and Mexico, particularly as it may affect small business.

I think it is important to state from the outset that when comparing the privatization programs in Latin America, I think we should define success to mean the process has created an environment conducive to making and fostering new private businesses, which obviously by definition is very often very small enterprises.

Financially speaking, Chile really stands out in comparison with the rest of the hemisphere, other than Costa Rica. I do not think it is appropriate to really talk about them in the same sentence, and yet you see quite often in the press Chile, Mexico, other countries all lumped together. Yet when I got the request from the committee, I could not imagine two more divergent experiences, so I was delighted to look into this.

Prior to 1988, really Chile had been the only country to take active steps to dismantle its State sector enterprises. This included 19 commercial banks, most industries, manufacturers; very importantly, the utilities, the electric power companies in Chile, and the pension funds, airlines.

The only thing that is left is Ladeco, which is a very large copper mining company. They have done something very interesting, which is essentially split it in half. They still have a kind of protective more State supervised part of it, and then they have another part that have invited foreigners to invest in, and one is going to shrink obviously, and the other one is going to grow. But mining has a particular political component in Chile that really cannot be underestimated.

In any event, Chile, because they still had a military authoritarian Government at that time, I think had more impetus politically than the other nations in the region to completely erase all of the vestiges of State socialism, and they did. In many cases, they were simply giving people back their property, because under the Allende Government, of course, they had seized an awful lot of companies, newspapers, what have you, and they, in many cases, simply reversed that process.

Mexico, on the other hand, as well as Venezuela, Argentina and Brazil, have all tended to take a much more incremental approach to privatization, and really for that reason it has been less complete.

In the case of Mexico, their first step, if you will, the first part of this process was during the 1982-88 period under Miguel de la Madrid, where because they no longer had the oil revenues, they no longer had the flexibility, they had to start reorganizing the State sector. This was not some inspiration. This was not a sea change of ideology or intellectual thinking. They had to do it, and therefore they set off.

The second phase was to then sell these State sector industries to what I described as naive foreign investors, starting from 1988. We have, in fact, seen literally thousands of public sector companies in Mexico closed or liquidated, and yet we do still have State

control in areas such as petroleum, electricity, railroads and the administration of airports. That is changing, however.

Unlike Chile, Mexico has placed very little emphasis on creating new export-oriented industries or in fostering private sector activity generally. Instead, Mexico has used foreign capital inflows and foreign debt to finance current consumption and subsidize the balance of payment.

I might add that Dr. Barnet had mentioned that they use a lot of the proceeds from the privatization program to pay off public sector debt. That is absolutely true. But in the interim the Government at the same time encouraged private companies to go out and borrow, so that today we have a total public and private sector foreign debt in Mexico of about $150 billion. If you add the foreign holdings of short-term T bills issued by Banco de Mexico, you are up to $160 or $170 billion dollars.

So from the perspective of the Banco de Mexico, the interest expense that they have to meet in terms of hard currency has grown enormously. It is almost as though the Brady Plan never existed. While you can argue, yes, the public sector debt is reduced, the total debt burden for the country has grown enormously.

Now, the one thing I would just like to say to finish the point about ideology and orientation as part of this privatization program in Mexico is that there has never been an orientation toward free market economics in the Salinas government. This is one of the great fallacies that they have been able to put forward in their propaganda.

These people have generally been guided by what you call a technocrat tendency, which is a socialist tendency. They clothe it in the terminology of the markets, the terminology of reform, but the basic essence of it is still very statist and very centralized. Where they have liquidated all these private sector entities, what they have done instead is use tax policy which, by the way, has police powers in Mexico. When the taxman bangs on your door, he can do just about whatever he wants. He can take you into custody. They have used tax policy in a way to not only raise revenues, but I think to terrorize the business communities so that cartoonists and commentators refer to it as "terrores mo fiscal," or fiscal terrorism.

It was mentioned before that the tax base has shrunk with the reduction in number of companies in Mexico, but I think it has also shrunk because they have been more worried about collecting taxes than they have been in creating new revenues, and that is really a basic problem.

In Chile, new capital inflows have generally moved into medium and long-term projects such as mining, agriculture, industry, and it has helped the country not only maintain a healthy balance of payments, but it has made a useful and long-term use of these investments. In other words, we have created assets which are going to throw off income, which are going to create jobs, and are going to serve as a real foundation for Chile in the future.

You do not hear people on Wall Street and the banking community talking about credit risk or country risk with respect to Chile. Even though their rating is relatively low in the grand scheme of things, they are stable enough in their foreign posture, their whole

Government finance and national financial profile is such that you really do not have the kinds of concerns in Chile that you do in Mexico or Argentina today.

Now, another very important point is that in Chile property rights are secure, and citizens or foreigners have the ability to seek redress in the courts or from their political representatives. Businesses may use courts to enforce agreements or to compel performance on a contract, and if need, be use a lien or asset seizures to satisfy a debt. Chile is a nation of laws. People who try and bribe government officials or engage in illicit activities run a very high risk of going to jail, and I say that with great admiration.

Chile may be at times a somewhat regimented and tough country compared to the way our legal system functions, but the streets are safe and it is a clean society.

Now, more importantly, the Chilean economy is free and open, and as I said before, the currency is fairly valued. There is a net excess of liquidity such that the pension funds that manage their private social security system, OK, a social security system that is entirely removed from the government, and therefore is not entangled in government finance, they had to invest offshore. They had to get permission to buy German Government bonds, and Japanese stocks and whatnot because there is nothing to buy. They did not have anywhere to put their liquidity.

Now, in Mexico, on the other hand, I am sorry to say that property rights are uncertain, even with the reforms we have seen today, and really the courts are dysfunctional. Once you get beyond the supreme court in Mexico the Federal and State courts are just a joke, and this is for Mexicans as well as foreigners. You do not have the ability to compel performance on contracts, to seek any sort of compensation. It is very, very difficult, for example, to go out and collect a bad debt in Mexico, because if the person who owes you money has any kind of political clout at all, you are simply not going to get anywhere. You can spend an awful lot of time and money on lawyers, but the bottom line is that it is not the sort of environment where it is easy for a business person to work something out unless they do it under the table. I will just leave it at that.

Now, I think we have heard a bit about the Mexican economy. Let me just say that the numbers on growth are hiding the reality. The reality is that an overvalued currency, taxes, other aspects of policy in Mexico are really decimating the manufacturing sector; things like textiles, steel, all kinds of equipment. This has a lot of implications for privatization, because obviously if you are going to invest in a country in a factory or whatnot you want to know that it is going to make money. You want to know that your investment is relatively liquid.

But really the only sector that has been expanding in Mexico in the last couple of years has been services, and especially financial services. This has been a result of the fact that most of the money has been going into the financial sector.

But if you look at steel, an area where Mexico should be very competitive, they just might as well close up. A Korean steelmaker can make steel, put it on a boat, ship it to Mexico, put on a truck on the Pacific coast, and truck it to Monterrey, and that steel is

still cheaper than the locally made product, and the wages of the steelworker in Monterrey are half of what they are in Korea.

So if you look at a company like Alpha, for example, which is one of Mexico's great industrial concerns, they just finished one of those modern steel mills, flat-rolled steel mills in the world, at 3 or 3.3 pesos to the dollar they might as well close because they are not going to make any money.

Now, let me just move on immediately to some of the points that we need to make with respect to privatization as far as just a quick comparison to kind of expand a bit some of Dr. Barnet's remarks.

I am very indebted to Roberto Salinas Leon, who I believe has appeared before this panel. We had a chat about this the other day, and he reminded me that a couple of years ago at a conference in Mexico City, Mexican Finance Minister Pedro Aspe, and Chilean Finance Minister Hernan Buchi had a very interesting back and forth on relative views of their privatization program.

The first vital issue is transparency. In all of the Chilean privatization, there has been a very high degree of transparency as to the sources and the uses of the funds. How the money was raised, distributed, et cetera, is just public record. You go down to Chile, you can find this stuff in a library or in the government office that was responsible for it.

In Mexico, on the other hand, there is absolutely no way to determine how much was paid for some of these State-run companies, or who actually made the purchases. Because of the opaque nature of the Mexican legal system and the use of nominees and other mechanisms, it is really very difficult in Mexico to oftentimes find a beneficial owner of a company or an asset.

I will give you an example. In, I believe it was 1990 or late 1989, when Mr. Salinas moved against La Quina, the former head of the Petroleum Workers Union, they seized many of his assets, but Raul Salinas, the brother of President Salinas, has come into the possession of La Quina's ranch up along the U.S. border. There was no transfer, no documentation, no taxes paid.

There is an old gentleman, who is a local, who holds the ranch in his name, but it is very clear that this is Raul's ranch.

Unless you look at it that way and say who is this guy affiliated with, with what group is this guy a part of you, you will never understand what is going on.

A second big difference, I think, between Chile and Mexico is the question of participation, and this has already been touched on by some of the other witnesses. In Chile, the privatization of State-owned enterprises involved a large-scale distribution of shares to the citizenry, and this gave them a real tangible stake in the future.

As Dr. Salinas put it very well to me this week, he said, "In Chile, they created a new ethic of ownership by spreading the proceeds of the privatization widely among the public. The success of Chile is that they embraced the notion of popular capitalism."

In Mexico, on the other hand, it has already been stated that privatization involved a small group of domestic and foreign investors, former monopolies and telephone, banking and other sectors have been involved in the private cartels. Whereas Chile created a new

ethic of ownership, in Mexico the privatization program has been run by and for the ruling elite with little or no public accounting.

In fact, as a joke sometimes some of my colleagues have referred to it as PRIvatization, with the three capital letters in the beginning of the word. It is just an interesting coincidence.

A third aspect of the real difference between Mexico and Chile is the issue of strategy. In Mexico, the government started with the smaller State-run companies, a lot of trusts and nonoperating corporations that were liquidated, and then worked their way up to the bigger firms, the banks and some of the others.

In Chile, on the other hand, they decided to start with the big ones and do it right the first time, and then work their way down. This was the substance of the dispute between Aspe and Buchi in this conference. The Mexicans were kind of learning as they went along and changing the rules for each privatization as well. The Chileans just did it from the start; sold the big ones and went at it.

Now, the one thing I would say that really for me explains a lot of the differences is the objectives. In Chile, the objective was to restore a market-based economy based on private property, and there was a conservative vision here because of the government that was in power at the time.

In Mexico, it is my personal belief that the strategy really has been self-enrichment and stability. That is to say, enrich members of the ruling party, people in government and have enough cash on hand to hold this thing together while they conduct fraudulent elections, while they govern the country, as I think most people are aware, the way that they do.

There has never ever been a commitment to free market anything on the part of the Salinas government, and I think that is why, if you really talked to credit people on Wall Street, you will find that Chile and Mexico do not enter into the conversation in the same breath.

Now, let me conclude with an anecdote that I think ironically enough highlights some of the problems my firm has encountered in doing business in Mexico.

I am a director of a Houston oil trading company called Arriba Limited, which has extensive experience through the other members of the firm in Chile, Mexico and other parts of the region. Arriba holds a final adjudicated judgment from Harris County, Texas, against the Mexican Petroleum Workers Union, in excess of \$450 million. This amount includes both the original judgments, the two judgments for about \$260 million and then with penalties and interest over the last year. It has grown, as you can see.

The judgment arose after two separate defaults by the union on a delivery of waste oil in the early 1980's. The union, The Sindicato Pemex, was allowed to sell the product from scraping the tanks and everything else, and this is a very valuable commodity. I can be reprocessed into fuel oil and whatnot.

At any rate we have been unable to register or enforce this judgment in the Mexican court. We would not even waste our time. We have taken counsel on this. The lawyers say do not bother.

However, in Chile, a final U.S. court judgment was certified and accepted by the Chilean court in a matter of days, and we are now

using the Chilean legal system as part of our action against the union.

Even if we were in Mexico, even if we were in a court and hypothetically even if we paid everybody off equally, we would still lose because the political influence of the union, of the government, of Pemex, would just prevail. There would be no way you could have a clear outcome to that legal action.

At any rate, let me just close it there and anticipate your questions. But I think that the problem is, in a nutshell, is that Chile is a country of laws. It is a relatively market-based economy. Mexico, on the other hand, the privatization process has been crippled and truncated by the fact that this is not a free and open society, and where people are not entitled to information.

if I were a citizen of Mexico and I wanted to complain about the privatization process or file a lawsuit, there would be no way I could do it.

Let me end there, Mr. Chairman.

[Mr. Whalen's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much.

We have a difficulty. A vote is taking place right now, and we have from the time you heard those bells 15 minutes ago for a vote, so I am going to have a temporary recess. It will take about 15 minutes by the time we get over there and get back. It is 11:02 a.m. So, we will recess until 11:15.

I understand that may pose difficulties with some of you. Dr. Barnet, I believe you have to leave.

Mr. Barnet. I have to leave pretty soon, yes.

Chairman LaFalce. Well, if you must, you must. We must vote, and this will give everybody the opportunity to find the facilities at the other end of the room too.

The committee is in recess until 11:15.

[Recess.]

Chairman LaFalce. The Small Business Committee will resume its hearing, and we had just heard from Mr. Whalen when we broke to vote, and we were about to hear from Dr. Lynn Nelson from Virginia Commonwealth University, who has been for a considerable period of time in Russia, has produced at least one book, "Property to the People: Responsible for Radical Economic Reform in Russia." We are anxious to hear his perspective on the issues.

Dr. Nelson.

TESTIMONY OF LYNN D. NELSON, VIRGINIA COMMONWEALTH UNIVERSITY

Mr. Nelson. Thank you, Mr. Chairman.

I have been studying economic reform in the Soviet Union since Gorbachev's days, and after the time it broke up I started studying Yeltsin's economic reform programs. Since 1992, I have focused almost entirely on privatization developments in Russia, particularly concentrating on four Russian cities, which I selected to reflect some of the regional and economic diversity of Russia: Moscow, Ekaterinburg, Voronezh, and Smolensk.

When I am in Russia, I coordinate the work of several dozen Russian field researchers. During the past years, we have gathered data relevant to privatization in each of these cities from a variety

of sources: Public records, published and nonpublished material, personal interviews with more than 10,000 respondents, and participation in meetings devoted to privatization decisionmaking. We have conducted lengthy interviews with officials, opinion leaders, enterprise personnel and general population samples.

My current research is funded by the National Council for Soviet and East European Research.

The principal objectives of privatization in Russia, as articulated in the State privatization program, include: Economic revitalization, improvement in enterprise efficiency, provision of a social safety net, financial stabilization, and the creation of conditions conducive to foreign investment.

Beginning in 1993, the priority was to be "people's privatization," that is, the distribution of State property for vouchers. In this presentation I will evaluate the success of the privatization program in achieving its objectives, with particular attention to the privatization of production enterprises.

Privatization in Russia has been quantitatively impressive. I do not need to repeat those figures. You have already heard them. These very widely circulated figures mask, however, less positive qualitative features of the Russian privatization initiative. In reality, it was clear by the end of 1993 that voucher privatization was not being embraced where its acceptance was the most crucial among enterprise personnel and that the promise of fair property distribution among the population was not being realized.

Inadequacies of the privatization program contributed importantly to the worsening of Russia's economy and to the political conflict of September and October 1993, which produced a backlash among a substantial number of voters in December.

The most striking deficiency of the voucher privatization program is its lack of acceptance among directors and workers in the production enterprises which were supposed to be the objects of voucher privatization. Throughout Russia, among those enterprises that had been transformed into joint stock companies by the end of the year, more than three-fourths has chosen the variant of privatization which allowed workers to own 51 percent of a company's shares from the start, with an opportunity to buy additional shares — thus, effectively precluding the possibility of people's privatization in those enterprises.

The State Property Management Committee did not go to that voluntarily. They did it because they had no alternative. Their preference was to have workers as minority owners, but they were not able to attain that objective because there was too much pressure from interest groups comprised of workers and directors.

Therefore, this outcome, although it was not in keeping with the government's plan, was entirely consistent with the perspectives of directors and workers that we have interviewed. Only 5 percent of the directors in our study this past year favored voucher privatization over other methods of privatizing, and we think it is significant that fewer than 20 percent of privatization officials preferred voucher privatization to other privatization methods. These are the people who are involved in making privatization decisions. Most of them do not favor voucher privatization.

In the general population also, voucher privatization was the choice of only 7 percent of our probability sample of 4,000 respondents. By the way, those figures are completely consistent with other public opinion data that has been collected on this subject.

It is widely acknowledged that a large proportion of Russian enterprises need to be restructured in the interest of efficiency. Yet, the voucher program has not clearly promoted fundamental restructuring within most privatized enterprises. Most management teams have remained intact after privatization, and there is no indication that this is likely to change. Most workers have kept their old jobs. At most plants long overdue modernization has not begun. Most privatized production enterprises have no foreign investments, and most have not sold shares for much needed working capital.

Attracting foreign investment was one of the major priorities of Chubais, the director of the State Property Management Committee. He has been very unsuccessful in achieving that goal. I will speak to that later.

It is true that State ownership had declined, but because of inattention to such critical factors for economic development as the maintenance of supply and distribution networks during the transition severe disruptions have resulted.

The exclusion of outside investors might be seen as self-defeating for enterprises if outsiders were offering money in exchange for ownership of shares. But voucher auctions do not bring money to enterprises. Sometimes money does change hands through voucher auctioning, but ironically the exchange does not benefit the enterprise whose shares are being acquired in the process. Most of the money that has been paid to individual Russian citizens who sell their vouchers for perhaps enough to buy a bottle of vodka or 3 kilograms of butter, and the speculators who trade in vouchers.

There is a fundamental contradiction between the voucher program's underlying political objectives and its stated economic ones, and it was only a matter of time until this contradiction created both a crisis of production and a crisis of political legitimacy.

In nearly every important detail the Yeltsin Government's privatization program is intended to promote the realization of political, more than economic, goals. On that point Anatolii Chubais is clear. When we interviewed him this past August, he told us without hesitation, "This is not an economics program. It is a political program. It is 5 percent economics and 95 percent politics." I submit that both are important certainly, politics and economics, but that is my point, both are important. In the Russian privatization program, the economic side has been almost entirely left out of the equation.

Nor does Chubais hesitate, in addressing colleagues, to make very gloomy, long-range predictions for the prospects of a very large number of privatizing enterprises. In a July 1993 speech he warned, "The biggest price that we will pay will come tomorrow. The main danger to the whole privatization program is the risk it will face when some of the privatized enterprises, or probably most of them, become bankrupt." Russia's privatization planners inherited a faltering political system, it is true. Their mistake has been

in not seriously addressing problems of industrial performance and misplaced incentives.

The Gaidar-Chubais team established other priorities. Their energies were focused more on destroying the existing command system than on building an improved production system.

The Russian Government's privatization program established a process for divesting the State of property without first developing procedures for facilitating the survival of those newly privatized enterprises in an alien economic environment. Divestment was the simpler of the two tasks by far. The second need was not adequately or even seriously addressed by the privatization planners. This has been the privatization program's most costly defect, whose negative consequences have already been enormous and threaten to accelerate even further in both the economic and political spheres.

The voucher program has been showcased by Boris Yeltsin and his planners as the vehicle through which the property accumulated through decades of Soviet rule would be equitably returned to the people. "We do not need a few millionaires," Yeltsin proclaimed after the voucher program was unveiled, "we need millions of owners." Yet voucher privatization has failed to deliver on its promise of equity.

For most Russian citizens, an amount of investment in Russian enterprises that could be meaningful in even a symbolic sense remains elusive. With the new privatization, there is not even a pretense of broad social equity.

Public confidence in the voucher program has been seriously weakened by special regulations which benefit enterprise personnel who work in the relatively small number of enterprises that are seen as particularly desirable. People who are not employees of those unusually successful firms are disadvantages in conspicuous ways.

Nor does the opportunity to exchange personal vouchers for shares in investment funds offer a promising solution for most of the millions who have chosen that option. By the end of 1993, more than 600 voucher investment funds were registered in Russia. Together, these funds had attracted more than 51 percent of all vouchers that had been issued. But today most investment funds are not paying dividends because of the difficulties faced by the enterprises where the vouchers have been invested. By now many funds have either stopped functioning or are selling large number of vouchers at stock exchanges in the hope of being able to make at least one-time payment to their investors.

I have been asked to comment on who the beneficiaries have been of Russian privatization. Some groups inside Russia have gained substantially through privatization. A number of powerful financial groups have acquired undervalued enterprise shares through voucher speculation. Individuals who had liquid assets that were available for investment following price liberalization in January 1992, and these people were not average Russian citizens, have been presented with extraordinary opportunities.

Many members of the old Communist Party nomenklatura have taken advantage of their positions and power in this time of economic chaos to secure valuable assets for themselves and for their associates. A number of enterprise directors have found themselves

strategically placed to transfer the control of State property into their own hands. Russians with an entrepreneurial spirit but lacking nomenklatura connections or large sums of money have had less success.

New business startups have been disappointingly few since the beginning of the privatization program, and government inattention to this critical area has been conspicuous since 1991.

Russia's production system, once mighty, has been severely weakened. The lives of most Russian people have worsened dramatically since 1991, and public opinion research shows that most are fully aware that the promised social safety net has not been provided. A restive populace discourages the foreign investment that the Russian economy desperately needs. So, the privatization program is working against the interest of Russia's economy in that regard.

The hardship experienced by Russia's citizens has spawned ultra-nationalist backlash and put at risk fundamental social and cultural institutions. Anti-Western, especially anti-American, sentiment has spread rapidly. This sharp turn in public opinion has been fed by both ultra-nationalism and a large number of analyses which are regularly featured in prominent Russian periodicals, which suggests a direct link between the economic and military interests of foreign governments and firms on the one hand, and the rapid deterioration of Russia's economy, on the other.

Finally, recent political developments and the continuing vitality of key elements of the command system demonstrate clearly that a point of irreversibility of reforms, which has been a prominent justification for rapid privatization, has not been reached. For example, the Yeltsin decree on December 24, 1993 gives branch miniseries even more control over enterprises than had been the case earlier.

Finally, I will address the question of U.S. Government policy regarding privatization.

U.S. Government officials have offered consistent and highly visible public support for Russia's economic reforms since the breakup of the Soviet Union, and they have repeatedly encouraged the privatization initiative under Chubais's direction. Further, a number of advisers to the Russian Government are widely viewed in Russia as representing United States' and other Western interests.

The literature which has been generated on the subject of recent economic reform in Eastern Europe provides no adequate evidence that constructive economic reform had to trigger the precipitous declines in production, research and development support, and economic well being among the population that Russia has known since the onset of the Yeltsin-Gaidar economic reforms. It is estimated today that only 30 percent of Russians can purchase adequate food.

The United States, having unhesitatingly supported some of the most flawed elements of the Yeltsin Government's economic reforms program, is now implicated in the reform initiative's negative economic and political impact. A decision to abandon this ineffectual policy course is overdue.

Thank you, Mr. Chairman.

[Mr. Nelson's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Dr. Nelson.

Our next witness is going to be Mr. Daniel Singer of the Fried, Frank, Harris, Shriver & Jacobson firm. However, the bells rang approximately 9 minutes ago, indicating another vote. I have not voted.

Glen, have you voted on this one?

Mr. POSHARD. Yes.

Chairman LAFALCE. I am torn between turning it over to you and have you listen to Mr. Singer's testimony; in which case I will miss it, which I do not want to do. We will recess for about 10 minutes, so I can vote and come back. I do want to hear everyone.

[Recess.]

Chairman LAFALCE. I apologize that the legislative schedule interferes with this hearing, but that is the nature of the beast. Let us go on to Mr. Singer's testimony.

TESTIMONY OF DANIEL SINGER, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON

Mr. SINGER. Mr. Chairman, thank you.

In listening to the other testimony this morning, I have come to realize that I have a very different perspective on the privatization process. In particular, as that process relates to small businesses, the only area with which I am familiar. That perspective relates to the real estate development business in a small corner of Poland. I think that I am optimistic more than anything else.

The only reason for my being here this morning is my experience hands on in attempting to create small businesses by the privatization of land in Poland.

The real estate business in the United States and elsewhere is quintessentially small business. One deals in small units of subcontractors, of material suppliers, and general contractors. Almost universally, those are small businesses.

The privatization that I know about does not involve only the transformation on the ownership side. The privatization that I have been involved in will result, I expect, in the creation of new assets where there are now only fallow fields. Creation of new businesses, small businesses, where none had existed previously, and with the creation of the jobs that are associated with those new businesses.

Turning to the legal structure, which is the particular niche I was invited to address, it is my judgment based on my own experience in Western Poland that the privatization task that we had set for ourselves — "we" being a complex of a government agency, and the banks, the developers, the architects, and the equity capitalists — can be accommodated by the present legal structure in Poland.

The critical elements in the present existing legal structure are: First, that the agency that owns the State farms in Poland can dispose of those farms in a negotiated process, rather than in an auction or in some kind of open tender, and, second, that the lands are free of what in Poland are called "reprivatization" claims, that is, that the pre-World War II owners of the particular lands involved have no legal right to claim against the particular lands that are being transferred to the new housing development ventures.

It is not a perfect legal structure. There are many areas in which one would want to have changes in the legal structure in Poland that would permit more American style real estate development business.

Regardless of how one feels about the American style real estate development business, one thing that we do know is that at least on the up side it works. On the down side, the banks generally get their pound of flesh. The fact that the process works in the way that I have described it in the United States, and to some extent in Poland, allows for a higher loan to value ratio from banks and other lending institutions.

About the only impediments that directly involve the legal system in Poland are those impediments that are more quantitative than qualitative in nature. The system works more slowly. It is less perfect and surely less sophisticated than we have in this country.

A year from now I could come back to this committee with a more precise judgment about the kinds of legal changes one would want in Poland in order to make the process work more perfectly. But it is my judgment, based on my experience over the last 9 months in Poland, that there are no serious legal impediments to the kind of privatization that I have been involved in.

The good stuff in my statement begins on page 6, which is a more detailed description of the particular enterprise in Poland in which I was acting to assist the Polish Government agency that acquired the State farms by statute after 1989, and has the responsibility — in addition to operating the farms — to get rid of them.

I will conclude there, Mr. Chairman, and allow the questioning to commence.

[Mr. Singer's statement may be found in the appendix.]

Chairman LaFalce. All right. Thank you very much.

I think that I have learned over the years that the best thing to do at this point is not to ask you questions, but to ask you if any of you have any comments that you would like to make regarding the testimony of the others, either to underscore points that they have made, or to take issue with points that they have made.

Mr. Waddell.

Mr. Waddell. Yes, I do. I think that there is a wide divergence of opinions and perspectives here today. I think that all of us will probably want to join in. I will try and keep this brief. I know that I did not in the opening.

But first, let me just say that I think that a lot of what you have heard this morning needs to be put into a little more context than perhaps was provided. I think that Chile was held up as an excellent example of privatization that has gone forward and been successful. I think that if these hearings were held 10 years ago, we probably would have heard the opposite. We would have heard that a lot of the companies had come back to the government through business failures. They were only forced into the private sector a second time against the will of many people. That the program was probably not all that successful.

The fact is that market reform and transformation of economies takes a long time in order to be successful. Many of the reports that we are hearing this morning I view as being midstream com-

78–333 O - 94 - 2

ments on some of the difficulties and not really some of the benefits, because they have not yet worked through the system.

I agree with many of the comments that were made about the Mexican legal system. I think that it is very clear that there is a need for reform in that area. I think that the U.S. Government, however, have very actively been promoting the idea that an environment needs to be created in order to enable privatization to proceed successfully.

Chairman LAFALCE. How so? To tell you the truth, I think that the United States in its desire to promote passage of NAFTA looked the other way for years and years of virtually everything that was taking place in Mexico.

Mr. WADDELL. I am sorry. I am talking from a more global perspective in terms of privatization as a worldwide matter.

Chairman LAFALCE. You mentioned Mexico. That is why.

Mr. WADDELL. I do not know that the U.S. Agency for International Development has assisted in Mexico in any fashion. But the general technical assistance programs that are promoted look not only at the transactional elements in privatizing for the sake of privatizing, but also in terms of creating a financial sector and a legal sector that are supportive of private sector development.

Chairman LAFALCE. I am just not sure if that is true in practice as opposed to theory. I do not dispute what you say, but I would certainly not posit that.

Mr. WADDELL. Actually, you would have to get a different witness to comment on Mexico.

Chairman LAFALCE. I am not on Mexico now, but I am speaking of Poland.

Mr. WADDELL. With respect to some of the specific points that were made by Dr. Nelson, I guess that I can quibble with many of the issues that are raised in the papers, many of the points. The fact that only 5 percent of managers of large enterprises favor the voucher privatization route is not surprising to me. Many of those same managers were actively trying to acquire control of those enterprises at the time. The extent to which the voucher privatization program was successful in introducing other investors and other owners into the enterprises was a disappointment to those managers.

Their reaction has been very much to try and keep control to themselves to the extent that it was possible. The emphasis on foreign investors was essentially dropped for a very pragmatic reason. It was not working. We participated in some of the early efforts to attract foreign investors into the Soviet Union, the former Soviet Union. It was a very difficult sell.

The macroeconomy was falling apart. There was no political stability. There was no rule of law. In that environment, you will not get foreign investors attracted, whether or not you have a voucher privatization program.

The emphasis on vouchers was a pragmatic compromise in my view to allow the program to move forward with some degree of speed. I agree with the statement that Mr. Chubais apparently made. It was a political decision. It was a compromise that was necessary in order to move forward. The government at the time was heavily criticized for not making any progress of any kind. To

continue to search for foreign investors and core investors would not have produced any types of significant results.

Chairman LaFalce. That is one thing. It is my personal opinion that there has been too much concern about pervasive privatization. Almost all is irrelevant other than the fact that privatization has been taking place. It reminds me very much of my unique position on the Banking Committee. Every other member when the RTC was created would have the RTC come in and say how many institutions have you closed today. The yardstick of success was the number of savings and loans closed. To me, this seemed like madness.

It seemed to me that we ought to close those that need closing, and we ought to keep alive those that possibly could go. There was no urgency to close 80 of them. That certainly should not be the yardstick for success.

One of my concerns is that our yardstick for success has been how many privatizations are taking place. Oh, my God, 750 out of 1,000, that is great. Forgetting the problems, the down side of privatization. The unemployment, and a whole slew of others. Much less the equity of it.

I just do not think that this has been adequately considered by those governments and entities, whether it is the IMF or World Bank, where it is promoting privatization. I think that it has been full speed ahead, damn the torpedoes.

Mr. Waddell. I agree that in some parts of the world that it is better to be deliberate.

Chairman LaFalce. I say this very tentatively. Everything I say on the issue, I say tentatively, in the spirit that I could well be wrong and change my mind tomorrow after I listen to you. Or not even tomorrow, but in 15 minutes.

Mr. Waddell. I think that some of the larger privatizations in Latin America and in Asia, that it is appropriate to be deliberate, particularly when you are divesting a monopoly. You need to worry about the regulatory framework being in place. You need to be worried about the impact that that change might have on important users of electricity, telecommunications, and so forth.

So I think that that is appropriate. I do, however, believe that in the context of Central and Eastern Europe and the former Soviet Union that any delay, you pay a very substantial price for that.

As I tried to outline in the beginning of my testimony, the decision of how and where to privatize involves a whole series of tradeoffs. There are no perfect solutions to that issue. But from my own personal experience in selling enterprises in Poland and Czechoslovakia, and conducting voucher privatization programs in Russia, the longer you wait, the more serious financial problems the enterprises are in. Any delay that you take of 6 months to a year severely complicates the process of ultimately being able to sell the enterprise.

Chairman LaFalce. I do not understand why that should be the case.

Could you not make a State-owned enterprise leaner and more efficient, and therefore assist the privatization effort, and ameliorate the economic dislocation that can come through a privatization?

Mr. WADDELL. That is precisely the issue. The answer is no. No one can do that in many countries, simply because no one is recognized as an owner of the enterprise. Because we are now in the era of economic transformation, the government is not recognized as having legitimate ownership interest and control over the enterprise. You have heard how the court systems in many places do not work. There are no outside owners.

Chairman LAFALCE. Let me just stop you there.

Is that true that in Mexico that there is not considered to be a legitimate owner of a State-owned enterprise? Is not the State considered to be the legitimate owner? How can you have privatization unless there is a legitimate owner in the first place who can legally transfer title and ownership to the private sector?

Mr. WADDELL. I am sorry. Maybe I was not clear. I am conceding that there is room for deliberate pacing of activity outside of the former Soviet Union and Central and Eastern Europe. I think that most of us recognize that.

But within the context of Poland, Czechoslovakia, and Russia, there is no one really exerting ownership interests. There is no one protecting the interests of capital in many of these enterprises. There will not be until privatization is complete, and there is an ownership group in place. It is for that reason that in that region that I think it is extremely important that the process be accelerated to the extent possible.

Chairman LAFALCE. Of course, this differs in the former centrally planned economies than for other countries.

Mr. WADDELL. That is correct.

Chairman LAFALCE.

Mr. WADDELL. Can I just make one concluding statement?

Chairman LAFALCE. Sure.

Mr. WADDELL. I think that Dr. Nelson in many of his comments has compared the Russian privatization program to an idealized version of how it might work in the United States. I do not think that you need to do that. I think that you can look right across the border in the Ukraine, and see the impacts on a country where there really is no progress being made toward privatization. Most of the comments and most of the critical comments that Dr. Nelson has made hold up at least equally as well in the Ukraine, and probably to a much greater extent.

So I think that a lot of the implications that the voucher privatization program has created problems in Russia really miss the fact that there are other economies that have not created these programs, but are facing even more dramatic difficulties.

Chairman LAFALCE. Thank you.

I will go to Dr. Nelson, and then to Dr. Aslund.

Mr. NELSON. I would first like to respond to the point about who protects ownership interests of the State in the case of the transfer or property. Perhaps Mr. Waddell has forgotten about the property fund arrangement that was created in Russia. As this program was set up, it was intended to have a system of checks and balances. There is a State property management committee, which was under the oversight of the executive branch. There was a property fund structure, which was under the oversight of the legislative branch.

The property fund's responsibility was very directly to represent the interests of the State in a variety of ways. That activity was terminated by Yeltsin decree, but very much against the interests and the wishes of the parliament.

What I would like to say in general about a variety of points that are being made is that assumptions that have been made here, are very rarely questioned seriously by people who speak for the West, when they talk about privatization in places like Russia or Eastern Europe. Assumptions about speed, assumptions about the importance of macroeconomic stabilization no matter what the cost. Assumptions which have never been tested. People have been writing about the history of East European privatization as if we could learn a lot from the history of this process. As you know, it did not start until a few years ago. The historical record is so thin for the kinds of conclusions that people have been reaching about it as to make any historian shudder.

The problem that I see with all of that is that most people do not know enough about the specifics of the situation to question these assumptions. For example, if anyone on this committee could read the most popular Russian newspapers, you would have no question in your mind about how successful privatization has been in the minds of the average person. Because it is very obvious. The problem is that it is interpreted for most American analysts by people who have those assumptions in their minds.

Chairman LAFALCE. If you listen to the people from the World Bank, for example, they just paint the rosiest picture of everything that is taking place.

Mr. NELSON. Sure.

Chairman LAFALCE. It runs counter to my intuitive knowledge. Whenever that happens, I am troubled.

Mr. NELSON. The last time that I was in a conference session in which Professor Aslund participated. The question that I asked at the time was whether the Russia that he seems to have been describing was the same Russia that I have been spending time in. I guess that I would repeat that here.

Because the Russia that I know, and I do know what the newspapers say, and I know what most of the public feels from surveys that are done, the Russia that I know is a Russia where most people are very dissatisfied with the privatization program contrary to Professor Aslund's statements.

The issue is not that directors of course oppose it, because many directors are going to oppose it. That is not the issue. The issue is that voucher privatization was supposed to be the centerpiece of 1993 privatization. It turned out to be a failure on most dimensions. What has happened after the fact is that reconstruction has been taking place, as has frequently been the case here today. People talk about the need for foreign investment.

Chairman LAFALCE. Dr. Nelson, we are going to allow you to continue. We are going to allow Dr. Aslund plenty of opportunity to respond in approximately 10 minutes. I apologize.

Mr. NELSON. No problem.

[Recess.]

Chairman LAFALCE. The Small Business Committee will reconvene.

Gentlemen, 10 minutes after the call for the next vote, we are going to conclude. Enough is enough.

Dr. Nelson, I will give you 1 minute to wrap up whatever you were saying.

Mr. NELSON. Sure. The place that I will stop is with the phrase "midstream difficulties." It is easy to justify the mistakes we made and are continuing to make by saying oh, well, the difficulties are just midstream difficulties. My contention is that the difficulties are because of planning mistakes from the very beginning.

Price liberalization on January 2, 1992 crippled the Russian economy and it is still reeling from that decision. People who promoted price liberalization have justified it in a variety of ways, mostly theoretical. Usually they say that people who disagree with them do not know much about the requirements for economic reform in formerly socialist societies.

Chairman LAFALCE. Are you speaking of Dr. Jeffrey Sachs?

Mr. NELSON. Professor Sachs, and Professor Aslund, and some others. Yet, as they know, almost all Russian economists strongly disagree with them. So, it really comes down for American audiences to find out more for themselves, and pay less attention to what some of the experts say who have been committed to the Gaidar-Chubai's program and who are filtering all of this through their own lenses.,

Chairman LAFALCE. Dr. Aslund, you have a rejoinder, I am sure.

Mr. ASLUND. Thank you, Mr. Chairman.

First, I would say that reading Professor Nelson's paper here that I am amazed. This is not the Russia or the Soviet Union that I know. I lived for 3 years in Moscow in 1984 through 1987, and saw what a mess the system was. I traveled quite a bit through the country. To me, it is an amazement that it is possible to provide so much of a structure to the system.

To return to the point that you had heard about speed. To give you one figure. In Poland last year, industrial production increased by 35 percent in private enterprise, and failed by 6 percent in State enterprise. A large number of State enterprises are in fact, ownerless.

Chairman LAFALCE. They are what?

Mr. ASLUND. Ownerless. No one is really in charge of them. It says that one third of the State enterprises are really rudderless. They will collapse, because no one runs them.

I will give you a picture from Volgograd. I was down talking to an enterprise director there 2 months ago. It was a military industrial high tech enterprise. I went into the office of the director. It is plus 9 centigrade in his room. The telephones have been cut off. The electricity has been cut off. What is this man doing? He has not even set up a sales department.

This was an enterprise that was considered so important to the national economy that it was not allowed to be privatized. Now it has come virtually to a standstill; 2,000 out of 4,000 workers had left voluntarily. The rest were not getting paid for 4 months. This is the kind of State managers that you have. They need to be kicked out.

There are people who are simply unprepared to accept economic realities, and adjust to them. Can you imagine someone who has

been in charge of an enterprise for years, and has not established a sales department? But 2 years ago, it only sold to the ministry of defense, and then it did not need a sales department.

So this is the kind of reality that we are looking at. To return to Professor Nelson's paper, he is not distinguishing at all between privatization and the effects that this will have, which makes the argument very unclear. He is adding up all negative observations, but he is not offering an alternative.

The point about lacking knowledge of Russia is that this is a very messy administration. The question is what can you do at all to provide some kind of structure and responsibility in the system.

It is true that the nomenklatura is getting quite a bit, but it is getting far less than if privatization was not going on, because this is a situation when, what is not privatized, will be stolen very fast. Then we are coming to the question: But does not the State own it? No, not really, because the State is very amorphous, and it is not clear who controls.

What really happened was that Yeltsin managed to get a renationalization of the property to the State property organization, and thereby the State gained the possibility to privatize at all, which was not obvious from the beginning.

I think that it is rather pointless to point out that there has not been much restructuring as yet. The important thing is really the formal fact that you have got private owners. Then the question is what is the alternative. Sales take a lot of time. We have seen countries that have tried sales, but they have not succeeded very well in selling big enterprises. Small enterprises are fine.

Frequently, there is a confusion that sales provide money to the enterprise. Sales of the enterprises provide money to the State, but it is not obvious that money that could be invested should go to the State. I would rather prefer to see it going into investment.

The point is often made that the foreign investment has failed. Yes, to a certain extent. But still, Russia had officially $1.7 billion of foreign direct investment last year in enterprises. If you take it more broadly, $2.9 billion of foreign investment, which is quite a significant figure.

I would not only pick out Ukraine, but also Belarus. These countries have tried to move slowly, but in effect, they have not moved at all. So, if you do not utilize the momentum that is there, it is very difficult to get going. I hope with the outcome of the election in the Ukraine that they can at least start moving, but it does not look very fortunate. Then one is quite happy that Russia has managed to do so much.

So to conclude, my view is that Russia is a very messy country indeed. Therefore, we should not have very high hopes for how much that really can be achieved. But then see they managed to formally privatize more than 50 percent of the economy into 2 years in such a mess.

Chairman LaFalce. All right. The republics of the former Soviet Union are a special case, and Central Europe is another case. Each is different. Hungary had a mixed economy for a long time. Czechoslovakia and Poland, each is unique. They are profoundly different from other countries too, such as Mexico and Chile. Both Mexico

and Chile are profoundly different from the other countries and Mexico and Chile are profoundly different from each other.

So in each country, it would seem to me, that while you can have the same criteria for success, you ought to have multiple criteria. How many they should be I do not know, but dozens and dozens of different criteria. You give different emphasis. The more advanced the country, the more demanding you could be, it would seem to me. In comparison, Mexico is pretty advanced in comparison to the European and other countries.

Does anybody have any quarrel with the observations of Mr. Whalen, who did say that in Mexico there has been a much greater concentration of growth under privatization than before, that there are privatization efforts to benefit a rather elite group of individuals? Is this true or untrue?

Maybe just you, Mr. Waddell, would have expertise in Mexico. I am not sure.

Mr. WADDELL. Unfortunately, I do not know the statistics. But to just give the framework. If you want to privatize an enterprise——

Chairman LAFALCE. Is anybody concerned about this? Let me ask the question in a different way. Is there any group, the United Nations, the Organization for Economic Cooperation and Development, that is concerned about these equity issues, and is attempting to evaluate and give guidance?

You, Mr. Waddell, came out with certain criteria, did you not?

Mr. WADDELL. Yes, I addressed several criteria in my testimony, yes.

Chairman LAFALCE. Is there any international group? I am not satisfied that the International Monetary Fund or the World Bank is concerned about this. I think that they would just view it from the prism of economic statistics. I do not think that they look at the human dimension. I do not think that they adequately factor in social equity considerations.

Is there any group that is trying to do this, Mr. Singer?

Mr. SINGER. I do not know if there is a group. But what is curious to me is, frankly, the manner in which you ask the question. If you ask the question: "Is there wealth being created which redounds to the benefit in some or large measure of those who are entrepreneurial enough to take it in the small business context to create that wealth?" then in comparison to what existed before, it seems to me that the answer to your question is "yes," there has been a greater concentration of wealth. I think that if our project to build houses works in Western Poland, we are going to make some wealthy contractors.

It is the structure of your question that makes me uncertain as to what answer would really address the issue that you are raising.

Chairman LAFALCE. I think your perspective is of a very small business privatization and my question did not have that in mind.

No. My question envisions a large business where privatization was really available only for a small handful of individuals, perhaps at very favorable terms, perhaps with a loan from the State. Special financing arrangements just for this small clique perhaps with a market valuation considerably below what it should be in order that the individuals for whom the State did permit the fi-

nancing could make a rather large killing, et cetera. That is what I am talking about.

Mr. Whalen, did you want to add something?

Mr. WHALEN. Let me just throw this out.

The major difference between both Chile I think deliberately and Europe accidentally or because they had no choice and Mexico is that in Chile I think the goal, if it was enumerated at all, was to move the economy back toward the more private sector orientation, reduce the size of the State and in many cases give people their property back after it had been expropriated under the Allende regime.

In Mexico, we have been here before. This is the fourth major foreign financed bubble of the Mexican economy in a history that goes back to the 1820's and the 1830's. I think that the ruling elite in Mexico who are very sophisticated financially adept people who know how the world works and who have the best advice that money can buy in certain respects are more concerned with bringing foreign money in than they were in expanding ownership or in creating new businesses or in general seeing popular capitalism thrive. In fact, because of the distortions of the U.S. monetary policy that has been in effect, for the last 3 years where we have had negative short term, interest rates, you have had a vast amount of money flow in. There has been a certain inflationary component to this because they have to print pesos for you to buy your TelMex stock, and while they were trying to contain this financial market phenomenon and benefit from it obviously, they have squeezed industry and other sectors to keep inflation under control and, indeed, to get it down to single digit rates.

Now rates in the United States are going back up. There is going to be a tendency for people generally to move out of stocks and back into interest rate instruments and this wave of money from the United States that has made Mexico and many other emerging markets viable over the last 3 and 4 years is now disappearing. The question is what do we have left? What have we created with this inflow of capital that can help Mexico down the road pay its bills, create more jobs, make this a more prosperous place as I think you are alluding to for the majority or even some of the people.

To me it is symbolized in one essential point. With all of the restructuring, with all of the privatization in Mexico, oil is still the only sector that generates a net current account surplus. Even autos are in deficit now because Mexico is importing a lot of very expensive units, we are exporting a fair amount of low to mid-price units, cars and trucks, but even this sector is still in that deficit for the Mexican economy. This is from the perspective, the macro perspective of the economy.

Now we are not going to talk about drugs or anything like this. That is, of course, the largest export from Mexico right now by far. Just the profits from the drug trade are bigger than the total revenues of Pemex. But for me, the difference in Chile was that there was a European oriented economy that was essentially trying to clean up an experiment in socialism and one that was not well supported by the population. Allende was only elected with about 35 percent of the vote. In Mexico, they have never had an ethic of kind

of European/Anglo-Saxon business, free market enterprise. They have never had an approach to personal liberty that all of these other things are an outgrowth of. I think it is unreasonable, really, to expect them to have gone — and we have talked a little bit about expectations and images, I would have never expected the ruling party in Mexico to do anything other than what they have done with privatization, which was to enrich their friends, sell a lot of assets at below market value and generally behave with respect to privatization the way they behave in all other questions of governance. OK? If you are not accountable at the polls, if there is absolutely no right for information, there is no right to question people in authority, how can you expect to conduct a privatization so it is going to benefit the public. It would be unreasonable.

Chairman LAFALCE. Do you have a comment, Mr. Waddell?

Mr. WADDELL. I did. I think some of the premise of your original question was who is concerned about the equity, whether things are being undervalued and so forth.

Chairman LAFALCE. I do not know that there is adequate concern within our own Government, for example. We say we are concerned about foreign policy and there are many dimensions of foreign policy. Military clearly is one. Economic is another. Economic is more than foreign aid, bilateral and multinational. The guidance that we give privatization is perhaps the most important economic foreign policy we could have right now and I do not know that any administration, the Bush or Clinton, has the foggiest notion of where we have been or where we should be going.

Maybe I am wrong.

Mr. WADDELL. Yes. I think you are overstating the case. First, I do not know that we have any involvement in Mexico so I cannot tell you what the United States policy or posture on privatization has been. But in general, the process when there are sales is to open up the process and invite a wide number of bidders to come in and bid for a company. You may find that the price that is offered is lower than book value. But oftentimes book value is a meaningless measure because it does not relate to the real underlying economic value of the enterprise.

Chairman LAFALCE. Is not valuation of a company a very important duty of accounting firms, for example?

Mr. WADDELL. Certainly.

Chairman LAFALCE. Is there not some general conclusion within the accounting profession that the privatizations of large companies that have taken place historically, although it is changing now, have been undervalued for the most part?

Mr. WADDELL. No, I would not say that at all.

Chairman LAFALCE. No?

Mr. WADDELL. No.

Chairman LAFALCE. Because I have read that.

Mr. WADDELL. No, I have not. Generally, the value of a company is whatever someone will pay for it ultimately. The way you increase that value is by bringing in a larger number of interested investors and asking them to bid for the property.

The fact that we may prepare a valuation that asserts a different value, generally the value that is bid is higher than the value that we would put on it, based on our review of the business, itself.

The accounting records, it is hard to tell because a lot of State-owned enterprises have receivables that essentially are uncollectible. So, in an accounting sense they may have some value, but in fact, there is really little underlying economic value there.

There is a lot of ways in which accounting statements, particularly in the former Soviet Union and Eastern Europe, will not reflect true economic value of an enterprise. So, the best protection that a Government can have is to market the company very widely, look for competitive bids and, in fact, you may be over-focusing on the purchase price.

Chairman LAFALCE. If you are selling the company, if you are offering stock in a company as a means of privatization, it is a lot different, is it not?

Mr. WADDELL. Generally, the investor is looking at them in the same way. They are looking at what is the value of this company. If I am only buying 40 percent of the shares, I am still going to calculate what the total value of the company is and what I can use it for. That is the limit to which I will bid.

I think what you also need to be careful of is that a lot of the privatization activity that is conducted is not based strictly on price. The example of TelMex and other telecom systems around the world, a lot of bidding consideration is how much investment will a new investor put into the system. Will you commit to doubling the number of connections in the country in the next 5 years? Will you provide digital services to the following major cities? So there is much more of an obligation on the part of the investor — I just am cautioning you not to focus too much strictly on the reported price that was paid for the shares.

Mr. WHALEN. If I could just interject quickly two examples. If you look at the bank privatizations in Mexico, the prices are astronomical. They are out of sight, 3½ times book value. I think three or a little under three was the average for the five or so largest. But the point here was it was not the local price in pesos that was the important thing I think from the perspective of the Mexican Government. It was how much foreign currency they could raise from investors. So, obviously, the bias would be toward a higher price. Now in the case of TelMex, I think this is absolutely right.

You had Southwestern Bell come in as an equity owner, but really they were looking for two things. They were looking for hard capital in the form of dollars which in turn could buy equipment that they needed. You do not buy this equipment in Mexico that you need to modernize the telephone system. Then, second, they were looking for expertise which is an intangible. Southwestern Bell brings that to the table as well as AT&T and other companies now. How do you price that?

I think frankly AT&T is going to take over Mexico along with Southwestern Bell. They are just going to scoop the whole phone system up and replace it.

Chairman LAFALCE. Dr. Nelson?

Mr. NELSON. I would like to get back more directly to your question about equity. I do not think it is good for foreign policy concerns to be tied to equity within a country. But one thing that is important, Maxim Boyko and a colleague of his have written quite

a lot lately, using the concept of "stakeholders." Somebody used that term earlier today, I forget who. What Bpucp is doing is looking at who the different stakeholders are in privatization processes. The State as the former owner, employees, the population, ministries, a variety of people.

What needs to also be included in that kind of overview is participation of foreign governments and foreign financial institutions as also potential stakeholders. The point I am trying to make is that, while I do not think we should be involving ourselves with equity considerations within a country, it is critically important that we concern ourselves with considerations of how our participation in the privatization programs of other countries may be viewed as reflecting some kind of stakeholder interest that our Government might have. That is the problem that we are in now in a very big way. Certainly in Russia and in some other countries as well. It is a problem we should not create for ourselves.

Chairman LAFALCE. If I am going to be very responsible, if the Clinton administration is to be very responsible, what is it that we as the Congress, what is it that the Clinton administration should be doing with respect to this global phenomenon called privatization? Nothing?

Mr. WHALEN. I think the thing that we as Americans should do is encourage the most accountable democratic formulations possible as distant observers and then leave it to the local people to work this out.

Chairman LAFALCE. How do we do that, assuming that is what we should be doing? We will start with you, Mr. Singer.

Mr. SINGER. My experience has been as a volunteer, as you know, in Poland, assisting a Polish Government agency. My expenses were paid by USAID under a contract with the American Bar Association. I think that is just super duper as a way to bring market-oriented expertise onto the ground in a particular project in a particular place. I am very happy about that as a model for dealing with small business and smaller units.

I do not really know a lot about how one would get rid of the Nowy Huta plant in Southern Poland, but the Polish Government did get rid of it; they just closed it down and went on paying welfare to 10,000 families. They did not have much alternative. The fiscal drain is substantial. But in terms of at least one model, the A.I.D model of contracting out with various entities — I hope Mr. Waddell would agree with me — does not work so badly as a way of multiplying the impacts of what AID can do.

The housing development project that I was, and continue to be, involved in is being assisted by two agencies that had a substantial input of congressionally appropriated funds. One is the Polish American Enterprise Fund, and through that entity and others, the Polish American Mortgage Bank, both of which have been enormously helpful. We have had in our project no problem of finding entrepreneurial folks both here in the United States and in Poland. Individuals who are interested, in the case of the Americans, in making investments as foreigners in projects in Poland.

Mr. NELSON. It is a complex problem. The World Bank and the IMF certainly have legitimate roles and will continue to be in-

volved and western governments, being involved with them, also will be participants. But as a general principle——

Chairman LaFalce. Was the European Bank for Reconstruction Development involved?

Mr. Nelson. Yes, very closely. That is inevitable in today's world and probably desirable, but there does come a point when the involvement of foreign governments directly begins to appear inappropriate within a country. That is what we need to worry about. We need to worry about being too closely involved in the internal economic affairs, particularly the economic reform plans, of another country. It quickly begins to appear that we are serving our own interests in that process, whether we are or not. That is the way it tends to be interpreted and if that is not what we are doing, then we should stay out.

Chairman LaFalce. Is the IMF which is so concerned viewed as an instrument of the United States foreign policy in Russia?

Mr. Nelson. Yes.

Chairman LaFalce. And so if the IMF is saying let us do this, is it being viewed as being imposed by the west led by the United States?

Mr. Nelson. President Clinton has been quoted in Russian newspapers as having said, "Well, I told the IMF to do that." I do not know if that is right or not, but he is being quoted as having said that.

Chairman LaFalce. Yet Vice President Gore has taken issue with the IMF, has he not?

Mr. Nelson. Vice President Gore's visit to Russia after the December elections was very productive and fruitful. But what he was saying——

Chairman LaFalce. Strobe Talbot had some comments, too. What were Strobe Talbot's comments.

Mr. Nelson. He reversed himself after the December elections and said, "Well, maybe we have been pushing too hard after all."

Sure, they had been pushing too hard and it should not have taken the December elections for them to have known that.

Chairman LaFalce. Whereas Dr. Sachs said, "Oh, how could he have said that? We have not been pushing hard enough."

Mr. Nelson. Sure. They will continue to say that. If they had pushed harder, not only me, but several other analysts are convinced things would have been worse.

Mr. Whalen. Just a brief note——

Chairman LaFalce. Just keep giving money to AID so you can get contracts?

Mr. Whalen. I think these are wonderful examples of the ways that business people can help other business people, but to the extent members of the business community, financial community in Mexico are aware that the technical assistance from IMF has resulted in this horrific tax system they have now, the IMF is not well loved in Mexico. They tend to take, I believe, a rather statist view. Also they do not do good background and due diligence.

As you know, last year I testified before the Banking Committee about Viedra Negras, that project in Quajela, the World Bank was ready to finance. No one had checked on anything. No one had checked the backgrounds of the principals involved in that deal.

I think these large multilateral institutions may have seemed like a good idea at one point, but I would be just as happy if they would disappear tomorrow.

Chairman LaFalce. Mr. Aslund?

Mr. Aslund. Yes. I think it is comfortable to think like this. The State in a country first of all is the central administration. In former communist States, the legal system is extremely weak, and that concerns privatization. I think that one way in which a State can help another State best without distorting it is, by supporting the development of a legal system and privatization more broadly. These are central State activities. Therefore, I do not think that it means much of distortion.

I think that what Professor Nelson says here about the danger of pushing is important. I think it should be very clear that assistance should be within the framework of government policy, but I would also say that the privatization policy in Russia has been firmly seen as carried out by Chubais. Chubais and Yeltsin are being blamed for it, not foreigners. I would also argue that this has been very discretely done and part of it is that Chubais hardly ever as far as I can remember has referred to foreign advisors.

Mr. Waddell. It is funny. I did quite a lot of work in Russia, obviously, and the position of the American Government at that time was, "Don't tell anyone that you are here working on USAID projects. Don't say that you are a representative of the U.S. Government. Stay out of the newspaper. Let the Russians be the principals acting here and let them take the political credit or the political blame. Stay in the background. You are only here to help with implementation and to move things forward." I think that is the appropriate stance. I think in a number of countries outside of the former communist world, to have an adviser in a privatization agency, to help them to deal with western bankers and bids that are coming from western companies, it is an enormous comfort because this is something that they are basically unfamiliar with and as a result they have a very difficult time making decisions without the comfort and the perspective of someone who has already operated in that market.

Chairman LaFalce. Thank you very much.

Gentlemen, I had said we would conclude at the next vote. This is the next vote. I want to thank you very, very much. I will say now what I said at the beginning. I think it is an extremely important issue and I think this is something that is worthy of greater concern on the part of the U.S. Government and the U.S. Congress. I think the approach we take should be a delicate one insofar as this affects the internal affairs of other countries, yet to the extent we can give guidance and stand for certain principles and therefore be helpful, I think it is important that we do so. I am still not convinced that we have been adequately concerned about that at all.

It is so tough to make generalizations because of the situations of countries differ so much. The situations within the country with respect to different possibilities for privatization differ so much. But it seems to me you ought to have some grander set of principles to work against all privatizations in all countries that could be appropriately applied. If you do not start out with those fundamental principles in mind, you are almost surely more likely to

go astray or not be as successful as you could be if you did not have those principles. I do not think we have been keeping those principles, a set of broad-based socioeconomic principles broadly in mind.

Thank you very, very much.

[Whereupon, at 12:55 p.m., the committee was adjourned, subject to the call of the chair.]

APPENDIX

STATEMENT OF REP. JOHN J. LaFALCE

COMMITTEE ON SMALL BUSINESS

HEARING ON
"THE PRIVATIZATION EXPERIENCE: STRATEGIES AND IMPLICATIONS FOR SMALL BUSINESS DEVELOPMENT"

April 14, 1994

The Small Business Committee convenes this morning to examine the issue of privatization. It is an economic process which U.S. policy supports, but there remains substantial confusion about what it is and how it works.

It is imperative that we achieve a better understanding of the policy implications of this important means of economic transformation. Privatization carries with it the hopes of the emerging democracies, for whom it is the primary vehicle for creating market economies under a rule of law, and facilitating economic growth and development. If accomplished successfully, privatization can legitimately be expected to increase economic efficiency and provide broad-based benefits to a country's citizens. However, if poorly implemented, privatization may only serve to channel resources to the same or different powerful elite groups. The issue this Committee meets to consider is whether privatization in practice lives up to its promise.

The worldwide push for privatization in the past decade responds to both ideological and economic changes. Governments once committed to state ownership as a matter of ideology or to state-created enterprise as the quickest path to modernization, now see privatization and expanded private markets as the best means to increase competition, enhance efficiency, and meet urgent infrastructure and development needs. Numerous Asian and Latin American countries have made privatization a central feature of broader market-oriented reforms and democratization efforts, while reforms in Central and East European nations and the republics of the former Soviet Union are virtually synonymous with privatization.

Much of the hope surrounding privatization is based on the encouragement and support for small business that it can provide. Proponents herald privatization as a means for small-business entrepreneurs in particular to create their own economic opportunities and "grab a piece of the action," and in the process spur general development. The Enterprise Funds for Poland and Hungary were one manifestation of this approach.

Yet, however well-intentioned, the privatization process has not always resulted in equitable opportunities for citizens and businesses who wish to participate. Instead, we often see "patron" or "nomenklatura" privatization, which allows an elite with influence and power to control the outcome and rewards of privatization.

In Mexico, the Indian uprising in the southern state of

Chiapas reminds us that, however significant a country's economic reforms may appear, its success depends ultimately on significant improvements in equity. In this case, Mexico's removal of Constitutional protections against privatization of communal farmlands was one of the sparks that lit the fire of political reform nationwide. This morning we will hear more details regarding the consequences of Mexico's privatization strategies from our witnesses.

A world away from rural Chiapas, officials of the Russian Republic are also engaged in massive privatization of state-owned properties. Thousands of small businesses have been sold for cash in public auctions, and a system of private vouchers has been created to distribute ownership of medium and large-scale enterprises throughout the population. Privatization of the bulk of Russia's material wealth has set off a scramble for available assets in which corrupt, criminal and even violent methods are becoming commonplace.

In this environment, the persons who appear to have benefited most from privatization are the former elite of the Communist system, the "nomenklatura" of high-level economic managers and former party officials with access to information, political contacts and foreign currency. While even this privatization may be preferable to continued state ownership, surely we must strive to do better.

Countries as diverse as Chile, Malaysia and Poland have put up for sale their airline systems, trading companies, banks, transportation systems, telephone services, ports and power systems. Throughout the world, privatization has raised hopes for improved efficiency, reduced bureaucracy, new foreign investment and greater prosperity.

Many of these privatizations appear successful in dispersing ownership, enhancing efficiency and increasing competition. But, as experience in Mexico and the Russian Republic suggests, other privatization efforts have failed to show that private ownership and operation are more efficient or respond better to consumers and workers.

The problem may be, not that privatization per se is flawed, but that we have developed little basis to measure success. Too often, issues of social equity which should be central have been ignored.

This morning we have a distinguished panel of experts on privatization who will enlighten us on the process of privatization, how it operates in various regions, and what the successes and failures have been thus far. We will hear first from **Mr. James Waddell**, Executive Director of the International Privatization Group at Price Waterhouse. Mr. Wadell's organization has recently developed a data base on privatization for A.I.D.

Next, **Mr. Richard Barnett** is Senior Fellow and a founder of the Institute for Policy Studies. Mr. Barnett is co-author of the well-known book **Global Reach** and has recently published a sequel, **Global Dreams**. **Mr. Anders Aslund** is Director of the

Stockholm Institute of Soviet and East European Economics and currently is a Guest Scholar at The Brookings Institution.

Mr. Chris Whalen returns to our Committee bringing his in-depth experience in Latin America and a particular focus on Mexico and Chile. **Dr. Lynn Nelson** is a professor of sociology at the Virginia Commonwealth University. He spent half of the past three years in Russia and recently published a study on his research there entitled **Property to the People**.

Finally, **Mr. Daniel Singer,** Of Counsel with Fried, Frank, Harris, Shriver and Jacobson, will provide the legal perspective. He is a specialist for the Central and East European Law Initiative of the American Bar Association and has traveled to Poland to lend his legal expertise to the privatization effort.

Opening Statement of Congressman Walter R. Tucker
Committee on Small Business
April 14, 1994

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, FIRST OF ALL, I'D LIKE TO REMIND EVERYBODY THEY HAVE ONLY ONE DAY LEFT TO DEAL WITH THEIR TAXES. ON A MUCH MORE HAPPIER NOTE, I AM VERY PLEASED TO BE HERE TO LISTEN TO THE TESTIMONY FROM OUR PANEL OF WITNESSES ON THE PRIVATIZATION PROCESS THAT IS TAKING PLACE IN THE EMERGING DEMOCRACIES AROUND THE WORLD.

PRIVATIZATION IS AN IMPORTANT POLICY FOR THE U.S. TO SUPPORT IF IT IS IMPLEMENTED IN A FAIR AND EQUITABLE MANNER. ALL CITIZENS AND BUSINESSES MUST BE GIVEN THE OPPORTUNITY TO PARTICIPATE IN THE MARKET ECONOMY. WHAT WE MUST NOT ALLOW IS FOR THE FEW ELITE WHO CONTROL KEY AREAS IN A GIVEN SITUATION TO MONOPOLIZE AND CONTROL ALL THE OPPORTUNITIES THAT ARE CREATED THROUGH PRIVATIZATION IN AN EMERGING DEMOCRACY.

I AM ALSO VERY INTERESTED TO FIND OUT WHAT OPPORTUNITIES ARE BEING CREATED FOR U.S. SMALL BUSINESS TO TAKE PART IN THE PRIVATIZATION PROCESS . I THANK THE WITNESSES FOR COMING HERE TODAY TO UPDATE US ON THE PRIVATIZATION PROCESS, AND I THANK THE CHAIRMAN FOR CONDUCTING THIS VERY IMPORTANT HEARING.

STATEMENT BY ANDERS ÅSLUND
PROFESSOR AT THE STOCKHOLM SCHOOL OF ECONOMICS
DIRECTOR OF THE STOCKHOLM INSTITUTE OF EAST EUROPEAN ECONOMICS
GUEST SCHOLAR AT THE BROOKINGS INSTITUTION
BEFORE THE COMMITTEE ON SMALL BUSINESS
OF THE HOUSE OF REPRESENTATIVES
CONGRESS OF THE UNITED STATES
APRIL 14, 1994

Political Ideas and Considerations behind the Russian Privatization Program

Mr. Chairman,

Arguably, the most successful part of the Russian transformation has been the privatization. At present, more than half of the Russian labor force works in the private sector and it produces more than half of GDP. Characteristic of the Russian privatization has been that most of the property has been given or sold very cheaply to workers and managers of the enterprises in question, while much of the rest has been spread through privatization vouchers given to the whole population. The purpose of this statement is to clarify the ideas and practical complications behind the Russian privatization program. It is part of my current writing of a book on how Russia became a market economy.

The idea of privatization had been anathema to Soviet communism, and it was one of the last communist dogmas to go, but all of the sudden it was widely accepted in 1990. It was a

prominent topic since the Five-hundred-day program of the summer of 1990, even if it mostly used the misnomer "destatization" (razgosudarstvlenie). The emphasis on privatization has been great ever since, and a kind of reversed marxism seems to prevail in many Russian minds, presuming that no market can exist before private property has achieved hegemony. Indeed, the dominant domestic criticism both from right and left against the Gaidar reform was that privatization was not carried out before price liberalization. Alas, the disputes over how privatization should take place were many.

Early Ideas of Privatization

The Five-hundred-day program emphasized the need for an early and massive privatization based on the principles of the participation of a broad stratum of workers, a division between management and ownership, payment for privatized property, a variety of forms of privatization, liquidation of monopolies and priority to enterprises showing initiative.[1] The importance of the Five-hundred-day Program was that it established the need for a fast and massive privatization. However, its concrete proposals were poorly elaborated. A major idea was that privatization should generate large state revenues as state property should be sold which should help financing the macroeconomic stabilization. These ideas that are reminiscent of the Hungarian privatization strategy were largely discarded, but several authors of the Five-hundred-day Program insisted on them for long.

Under influence from the discussion in Eastern Europe, the idea of free distribution of property gained popularity. On July 3, 1991, the Supreme Soviet of the RSFSR adopted a law "On Personal Privatization Accounts in the RSFSR"[2] and another law "On Privatization of State and Municipal Enterprises in the RSFSR".[3] The main idea was that every citizen of the RSFSR was supposed to receive a certain annual amount, equal for all, on a personal privatization account with the state Savings Bank. The privatization account could be used for purchases of all kinds of property to be privatized on the whole territory of the RSFSR. It had to be used within three years. Privatization accounts had already been introduced in Lithuania. Also this law aimed at fast mass privatization, but it did not give any advantage to insiders in enterprises. The main problem with the law, however, was that it suggested very complex privatization procedures that were not likely to work. Its main lasting contribution was that it established the principle of free distribution.

The Soviet Union never managed to adopt a privatization law, but a draft law "On the Fundamental Bases of Destatization and Privatization of Enterprises" was published in June 1991, in competition with the Russian law on privatization.[4] It stated clear fundamental principles that largely ran counter to the Russian privatization law: the work collective should decide the form and order of privatization, and social security should be ascertained. The draft law stated nothing about speed and little about method of privatization, and the property right was

limited. Moreover, it emphasized reasons for which privatization could be impeded. Limited free distribution was envisioned, and like the Russian privatization law it argued that all citizens should have equal rights in receiving property shares.

Leading Ideas of the Russian Privatization Program

When the reform government was formed in November 1991, Anatolii B. Chubais was appointed Minister of Privatization. He had to start with a pretty clean slate with neither administration nor policy. The general mood was expressed by Boris Yeltsin in his big reform speech on October 28, 1991: "Impermissibly long, we have discussed whether private property is necessary. In the meantime, the party-state elite has actively been engaged in their personal privatization. The scale, the enterprise and the hypocrisy are staggering. The privatization in Russia goes on since long, but wildly, spontaneously and often on a criminal basis. Today it is necessary to grasp the initiative and we are intent to do that."[5]

A strong sense of urgency prevailed, because of a broad understanding that what is not privatized will be taken legally or illegally by the old elite. Speed was not only a matter of creating a necessary base for a new market economic society but it was also seen as an instrument of justice. This was a useful starting point. Various approaches were tested by the criterion whether they could be practically implemented and lead to a sufficiently fast process of privatization. An important

restriction was that the privatization had to be real, that is it had to lead to individual, and not collective, property rights. A whole new legal framework had to be constructed.

An important understanding in Russia was that public property was not very public. Usually, hidden quasi-property rights of stakeholders existed.[6] The pragmatic view of the Russian privatizers was that various stakeholders had to be given enough so that they accepted to be coopted into the privatization. The Russian decision-makers looked at Poland to learn primarily pitfalls to avoid and at Czechoslovakia to learn how to do it. At the same time, they were acutely aware of Russian peculiarities, such as a highly corrupt state administration. However, Russia had also helpful characteristics. Since nationalization had occurred so long ago, there were hardly any demands for restitution in Russia, which greatly facilitated privatization.

An early decision was to try to form a federal privatization policy, but to allow a great deal of flexibility within the framework of the federal policy. Another endeavor was to decentralize most of the actual privatization to the regional level, which was another means of speeding up privatization.

An initial step, announced already by Yeltsin in October 1991, was to transform large enterprises into joint stock companies.[7] At the same time, the nominally-public enterprises were in effect re-nationalized, because the bulk of the shares were supposed to be transferred to the state, that is the

privatization authorities and not, for instance, branch ministries. The purpose was to stop spontaneous "Nomenklatura" privatization of public enterprises and to impose a reasonably regular privatization process.[8]

Several alternative ideas circulated about who should benefit from privatization. The Five-hundred-day program had put all the emphasis on budget revenues. The Russian privatization law of July 1991 had discarded the idea of privatization as a means of reaping state revenues, but it lingered on. On December 29, 1991, "Fundamental Positions of a Program of Privatization of State and Municipal Enterprises in the Russian Federation in 1992" was adopted as a presidential decree.[9] This rudimentary privatization program reflected the new views of privatization, but much was still unclear. It contained explicit revenue targets from each of the next three years 1992-1994. The targets turned out to be easy to achieve because of the unexpectedly high inflation, but they lost all political significance, and privatization revenues became a measurement of the volume of privatization rather than significant in themselves.

In his October 28, 1991, speech Yeltsin initially outlined that the shares of enterprises would be divided between the state and the work collectives.[10] The transfer of property rights to the work force remained a high priority. Hardly anyone opposed it, and the question was only how much that should be given and in what form. A first authoritative answer was to be found in the preliminary privatization program of December 1991. The "members

of the work collectives" were to be given shares in enterprises that were transformed into open joint stock companies. The program stated that the workers would be given 25 percent of the company capital for free as preferential shares,[11] but this was to be further disputed and elaborated.

The purpose of giving a substantial share of the ownership to workers in enterprises to be privatized was not based on any ideology or concept of justice, but on a desire to facilitate fast privatization. Swiftly, the workers, frequently including management, were transformed into active advocates of privatization. As Chubais explained this decision at the time: "If we didn't accept that, the work collectives would hardly support privatization. But now they have 'suddenly' shown an interest in the law and started egging on the administration."[12] This decision contained several important elements. First, the workers would receive stocks only after their enterprise had been transformed into a joint stock company so they would not only push for privatization but also for corporatization. Second, the shares would be individual property, excluding the danger of collective property and Yugoslav-type workers' self-management with collective irresponsibility. Third, the government also harbored the hope that the workers would check illicit privatization by managers. In particular, the government was afraid that its decision to effectively nationalize enterprises would encounter resistance. Therefore, it was anxious to have the workers on its side from the very beginning.

The decision to give the workers in enterprises to be privatized stocks initially, meant that the workers were given preference over all potential outside owners. The privatization program of December 1991 cancelled the distribution of privatization accounts to all Russian citizens in 1992. Still, the idea of mass privatization was not abandoned. The privatization program prescribed rather loosely that preparations should be undertaken for the opening of privatization accounts before the end of 1992.[13]

The privatization policy included an acceptance of free distribution of a certain amount of shares to workers, managers and the population at large, but there was no clear concept of how much that should be given to whom, and there was no idea of what was to be considered just. This left a lot of room for negotiations and compromises. However, there was a firm conviction that the population as a whole should be involved, and that mass privatization should take place. Moreover, there was also an urge to combine the aims of achieving a reasonably broad ownership of shares and facilitating the emergence of strong owners. In effect, the initial distribution of shares to workers and managers meant that they were given more preference than the policy-makers intended or realized at the time as we shall see.

So far, we have not discussed foreign investment, and that appears appropriate. They did not play any major role in the privatization strategy. The proponents of fast privatization were afraid that any preferential treatment of foreign investment

would arouse a political outcry that would hamper privatization as a whole, while the adversaries of privatization were simply against foreign investment. In addition, key liberals realized that little foreign investment was to be expected under the unstable conditions of Russia. Still, foreign investment, both in joint ventures and wholly-owned enterprises, was allowed and no actions were taken to restrict them. The privatization program of December 1991 contains quite a bit about "the utilization of foreign investment in privatization". However, this title is indicative. Foreign investors were requested to do what Russian enterprises failed to, notably to take over loss-making enterprises and complete unfinished construction projects.[14]

The Russian privatizers never forgot that the ultimate purpose of privatization was to create a market. Therefore a number of restrictions were always present. Prices of property should preferably be set at a market, and the best rudimentary market is an auction. An auction price is be definition always a market price if several independent participants have been admitted. Another market-related principle is openness and transparency. A third related idea was to use the privatization process to develop markets, notably capital markets. Whenever open trade could be facilitated it should be allowed. A fourth tenet was that monopoly should be avoided, but that had to be sacrificed in many cases. The internal resistance against a breaking-up of large enterprises was great and left the privatizers with the choice of leaving the enterprise alone for

years or privatizing it as it was. A fifth principle was that excessive concentration of ownership was harmful, which led to the splitting of privatization into different blocks of shares and limits on stakes. It should be possible to oust incompetent managers, but it was also important to block outside raiders from just plundering functioning enterprises of their assets, and Yugoslav-type workers' management must be avoided, because of its neglect for profits and return on capital and general lack of responsibility.

Administration of Privatization

A vital precondition of the success of Russian privatization was the political arrangement. In stark contrast to Poland that did not even have a Ministry of Privatization during most of the first year of economic transition, Russia established one federal state authority that was responsible for privatization, the State Committee of the Management of State Property. Moreover, in the government one man was in charge of privatization, namely the Minister of Privatization and Chairman of the State Committee of the Management of State Property, Anatolii Chubais. It helped that Chubais managed to hold on to that position throughout the first two years of reform, and that he was promoted to Deputy Prime Minister, while retaining his previous job, in the spring of 1992.

More than any other reformer, Chubais succeeded in convincing President Yeltsin about the importance of his domain.

Chubais appears to have had frequent access to Yeltsin, and it is striking how many presidential decrees that have been issued in support of Chubais's privatization policies.

While there was no reform program, Chubais made sure to elaborate a comprehensive privatization program and he did so at break-neck speed. A first provisional program, "Fundamental Positions of the privatization Program" was adopted at the end of December 1991, and in late March 1992 the actual privatization program was ready. Chubais has continued to elaborate full-fledged programs also for the consecutive privatization.

However controversial privatization appeared, Chubais managed to gain a full political mandate for it. As soon as the first provisional privatization program was ready, Chubais induced President Yeltsin to contact Ruslan Khasbulatov, the Chairman of the Supreme Soviet, and the Presidium of the Supreme Soviet adopted the program unanimously at a joint meeting with the government on December 27, 1991.[15] A presidential decree of January 29, 1992, "On the acceleration of the privatization of state and municipal enterprises", introduced necessary regulations in order to keep the privatization process moving. However, parliamentary approval of a full-fledged privatization program was needed. In late March 1992, a draft program was ready for its adoption by the Supreme Soviet, but now the political mood had turned much more negative. However, Chubais worked hard trying to convince the deputies, and also made real concessions, primarily towards more benefits to both workers and managers.

After months of excited debate, the Supreme Soviet finally adopted both the and the Privatization Program for 1992 on June 11. As it later turned out, this was the last major reformist decision that the Russian Supreme Soviet was to take. Chubais had exploited a window of opportunity that was just about to close. However, he had the necessary legal base. For the rest, important decisions on privatization were presidential decrees, while less important decrees were issued by the government or the GKI itself.

During the first half year in office, Chubais built up the GKI at the center and local State Property Committees in each region. This organization was completely new, not as marred by communist practices and communist thinking as other state organs. In particular, it was created for one purpose, privatization, and was not confused by previous opposing tasks. Moreover, it was a highly decentralized organization, with about 400 employees at the GKI in Moscow and about 100 at a regional Property Committee.

While privatization legislation was federal, the execution of privatization was regional. Hence, the capacity of privatization became much larger than if it had been centralized. Nor could the process be stopped by any temporary upset in Moscow. Even major political crisis only caused moderate changes in the volume of privatization. Ardent adversaries of privatization, such as the old branch ministries or their remnants, were highly centralized. The privatizers could frequently mobilize regional authorities against adversaries of

privatization in Moscow, and since the regional authorities greatly extended their powers at the expense of Moscow, this meant that privatization benefitted.

The privatization officials astutely exploited the mechanisms of both the old and the new system. The initial privatization program of December 1991 contained "compulsory plan targets" for the privatization of enterprises in 1992 in ten specified branches in all regions - usually around 50 percent. This was a devise that would keep old Soviet officials working for the purpose of privatization. At the same time, monthly statistical reports with a multitude of tables were requested from each region in order to encourage all to keep up a sense of focus on privatization and hopefully compete over fast transfers of property. These techniques gave rise to many jokes about liberals exploiting to communist methods, but they worked.

Another method was to request various bodies to produce privatization programs. Centrally, the GKI made an annual privatization program. In each region, the Property Committee was obliged to produce its own privatization program. Most importantly, each enterprise that had been singled out for compulsory privatization had to elaborate its own privatization plan. Thus, exactly as in Czechoslovakia, enterprises were compelled to privatize, but they were entitled to choose how they wanted to be privatized. The Russian reformers carefully avoided the situation created in Poland after the privatization law of July 1990 which gave several interested parties a right to say no

to privatization.[16] Moreover, the Russian privatization program also allowed a wide group of enterprises to propose their own privatization, and a great many of these enterprises opted for early privatization, since both the managers and employees were to benefit. Thus, the strategy thrived on grassroots initiative of enterprising managers.

Privatization required hundreds of legal documents, but Russia suffers from an acute shortage of lawyers, and the whole legal system is in a deplorable state, small, poorly qualified and corrupt. This has been a permanent dilemma of Russian privatization The main approach has been to simplify as far as possible. Another element has been great tolerance towards transgression of central regulations, both for benign and malign purposes. The underlying assumption has been that what is not privatized will be stolen. Therefore, a somewhat irregular privatization is preferable to a general halt to privatization.

Yet, in few areas has the Russian need for foreign intellectual assistance been so great. A large number of Western lawyers and economists have been involved in the Russian privatization program, but complaints have essentially concerned how much they are being paid, not about the utility of their work. The main explanation is that the leading Russian privatizers, Chubais and his deputy Dmitrii Vasiliev, knew what kind of policy they wanted. They instructed their advisors about the framework of their policy, and their own policies were effective. Thus they obtained useful advice. This is in stark

contrast to the situation in Poland, where a number of Western advising companies initially advocated a British approach to privatization, which turned out not to function and large-scale privatization essentially failed in Poland. The foreign technical assistance provided to Russian privatization is likely to stand out as something of the most effective Western aid agencies have done to support post-communist economic transition.

The Coopting of Stakeholders

The perhaps most sophisticated part of the Russian privatization program has been its politics, how various stakeholders have been considered and coopted. The approach could either be described as pragmatic and shrewd or unprincipled. In any case, it has been deliberate and flexible. Chubais' advisors Andrei Shleifer and Maxim Boycko have described privatization as a redistribution of existing control rights over company assets between its stakeholders.[17] The strongest stakeholders were the work collectives, both workers and management. A third important stakeholder is regional authorities. A fourth stakeholder is the branch ministry. Finally, the population as a whole is supposed to be the owner of public property. The whole design of the privatization program was based on considerations of how these stakeholders could be satisfied or placated.

The outcome has been that the managers and workers have gained control over most of the shares, first through the distribution of 51 percent of the shares at a low price to these

insiders and then by additional purchases at voucher auctions or after them. To date, the workers have been surprisingly subservient to the managers, but that is likely to change as a monetary squeeze at long last is forcing enterprises to adjust to the market or close down. The regional authorities have been in charge of the execution of privatization, and they have benefitted from substantial revenues from the small-scale privatization. The population has received vouchers and they have either bought shares in the about 650 voucher funds or mutual funds for their vouchers or invested the vouchers themselves. Admittedly, the voucher price has stayed low as the insiders have taken most of the property, but at least people have got something, and all kinds of markets have evolved. The branch ministries, finally, have hardly received anything at all. They have stayed conservative and repeatedly called for the setting up of holding companies covering whole industries, which would only reinforce the monopolization of Russian industry. Fortunately, the branch ministries have largely lost.

Conclusion

A present, the new distribution of ownership is being tested. Recent reports suggest that a large number of managers have been sacked by dissatisfied outside owners in coalition with a limited number of insiders, typically including one director who wants to become managing director. However, it appears more common that enterprises simply grind to a halt without any adjustment worth

mentioning because nobody can threaten the managing director. Since inflation stays high at almost 9 percent a month in March, the drama has only started. In any case, all management power has been transferred to the enterprise level, and no authorities in Moscow hold any sway at privatized enterprises any longer.

1. Perekhod k rynku. Kontseptsiya i Programma, Moscow, Arkhangelskoe, August 1990, p. 68.

2. "Zakon RSFSR "Ob imennykh privatizatsionnykh schetakh i vkladakh v RSFSR", Ekonomika i Zhizn', no. 31, July 1991, p. 15.

3. "Zakon RSFSR "O privatizatsii gosudarstvennykh i munitsipal'nykh predpriyatii v RSFSR", Ekonomika i Zhizn', no. 31, July 1991, pp. 15-17.

4. "Proekt: Zakon Soyuza Sovetskikh Sotsialisticheskikh Respublik Ob osnovnykh nachalakh razgosudarstvleniya i privatizatsii predpriyatii" Izvestiya, June 26, 1991, p. 2.

5. "Vystuplenie Borisa Yeltsina na S"ezde narodnykh deputatov RSFSR", Izvestiya, October 28, 1991, p. 2.

6. Leonid Grigoriev, "Ulterior Property Rights and Privatization", in Anders Åslund (ed.) The Post-Soviet Economy: Soviet and Western Perspectives, St. Martin's Press, New York, 1992, pp. 196-208.

7. "Vystuplenie Borisa Yeltsina na S"ezde narodnykh deputatov RSFSR", p. 2.

8. Irena Grosfeld, "Prospects for Privatization in Poland", European Economy, no. 43 (1990), pp. 147-149, discusses the nature of Nomenklatura privatization. The implication was that state managers transferred enterprise assets to themselves, mostly together with powerful accomplices. The methods were many. A state manager could set up a small enterprise of which he was a major owner to which he sold produce of the state enterprise cheaply so that the profit pertained to his private enterprise and not to the state enterprise he managed. A popular technique in Russia was management courses. They could be provided by the manager and his friends to the state enterprise and they could be bought very dearly.

9. "Osnovnye polozheniya programmy privatizatsii gosudarstvennykh i munitsipal'nykh predpriyatii v Rossiiskoi Federatsii na 1992 god", Ekonomicheskaya gazeta, no. 2, January 1992, pp. 18-20.

10. "Vystuplenie Borisa Yeltsina na S"ezde narodnykh deputatov RSFSR".

11. "Osnovnye polozheniya programmy privatizatsii gosudarstvennykh i munitsipal'nykh predpriyatii v Rossiiskoi Federatsii na 1992 god", Ekonomicheskaya gazeta, no. 2, January 1992, p. 18.

12. "Privatizing State Property" (Interview with Anatolii Chubais), Moscow News, no. 3, 1992, p. 10.

78-333 O - 94 - 4

13. "Osnovnye polozheniya programmy privatizatsii gosudarstvennykh i munitsipal'nykh predpriyatii v Rossiiskoi Federatsii na 1992 god", Ekonomicheskaya gazeta, no. 2, January 1992, p. 19.

14. "Osnovnye polozheniya programmy privatizatsii gosudarstvennykh i munitsipal'nykh predpriyatii v Rossiiskoi Federatsii na 1992 god", Ekonomicheskaya gazeta, no. 2, January 1992, p. 19.

15. "Privatizing State Property" (Interview with Anatolii Chubais), Moscow News, no. 3, 1994, p. 10.

16. Roman Frydman, Andrzej Rapaczynski, John S. Earle et al, The Privatization Process in Central Europe (Budapest, London, New York: Central European University Press, 1993).

17. An excellent article on this that forms the basis of much of the following is: Andrei Shleifer and Maxim Boycko, "The Politics of Russian Privatization" in Olivier Blanchard et al, Post-Communist Reform: Pain and Progress, MIT Press, Cambridge, Mass., 1993, pp. 37-80.

Statement of Richard J. Barnet
Before the House Subcommittee on Small Business
April 14, 1994

I am pleased to appear here today to share some of the findings on the effects of globalization my colleague John Cavanagh and I have been studying over the past five years in preparation of our book Global Dreams which has just appeared. I would like to make some general observations about the social and political impacts of globalization, and in that context discuss the privatization program in Mexico. I have just returned from a visit to that country where I participated in seminars with Mexican economists, sociologists, journalists, and political figures with respect to the effects of privatization and other aspects of globalization on the Mexican people. I spent a year doing research in Mexico twenty years ago and have thought a good deal about that country ever since, but I am not a specialist on Mexico.

A major conclusion of our book is that economic integration is typically accompanied by political and social dissolution in various forms and to varying degrees. Nations and even neighborhoods are split as the gulf between the winners and losers in the integration of national economies into the world economy widens. Those who benefit the most from privatization, deregulation, and freer trade are investors, exporters, and skilled workers in export industries, and consumers, who in some cases have access to cheaper goods and services. Increased communication with the rest of the world weakens the hold of authoritarian governments, but it also opens up societies to the overwhelming influence of global commercial culture which is having a profound effect on education and family life. The penetration of American cultural products into Canada is a major political issue there, and there are signs of local resistance to the dominant role of U.S. movies, TV, and pop music in a number of countries.

The negative side-effects of the development model based on reducing government's role and enlarging the market's role--loss of employment and curtailment of government-financed social services--tend to be more widely felt than the benefits. Even in our own country the opening up to foreign investment and increasing emphasis on foreign trade is widening the gap between the beneficiaries of globalization and the larger numbers who experience these winds of economic change as a threat to job security, their economic prospects, even to their status in society. The negative social consequences are widely felt. Stroll down K Street in Washington, D.C. past gleaming office buildings filled with lobbyists, lawyers, and public relations firms serving global corporations, and keep walking. A few blocks east you enter anxious, crime-ridden neighborhoods where the unemployment rate hovers around 50 percent, and when children get together, the talk can quickly run to guns and funerals--their own. Baltimore's World Trade Center, the symbol of the city's global connectedness, is

just a few blocks from the remnants of textile factories and boarded-up shops, a slum with the highest concentration of teen-age pregnancies in the nation.

As American society becomes increasingly enmeshed in the global economy in so many different ways, what the influential economist Joseph Schumpeter called capitalism's "gales of creative destruction" have been blowing faster and harder. Millions of Americans are successfully connected to this new world economy, and they experience the winds of change as a caressing breeze. Professionals with the skills and connections to make use of the world market and high skilled workers in many export industries have done well. But tens of millions of low skilled workers who make up the bulk of the U.S. labor force have seen their pay, working conditions, and job security decline. Thousands of managers as well have experienced global change as a March wind.

All across America enclaves of prosperity that benefit from global connections can be found right next to neighborhoods with little left but memories of happier times. These swift changes in individual and community fortunes are often the results of investment decisions made thousands of miles away. As expectations of economic possibilities are lowered for many Americans and fears for personal security rise, the bonds of trust that hold society together are strained. In developing countries with high unemployment, low wages, and highly unequal distribution of income and wealth, the negative effects are felt by a large majority of the population, and the strains are much greater.

Whether privatization of state enterprises represents a net gain or loss for a society depends upon the specific circumstances, history, and culture. Whether it is in the interests of the majority of people in any given country to reduce or alter the role of government in the economy should not be treated as an ideological question. The answer depends on many factors, including the competence and honesty of government and the commitment of the private sector to support economic, environmental, and social goals.

Mexico offers a good case study of some of the most serious problems associated with privatization. To understand them, a little historical background is necessary. Beginning in the early 1930's the state assumed a leading managerial role in the economy. The nationalization of oil in 1938 triggered a national policy aimed at building up domestic industries, in many cases subsidized by cheap oil. Between 1930 and 1970 the number of state-run firms (parastatals) increased from 12 to 491. In the 1970's state intervention expanded dramatically in the belief that this would reinforce national sovereignty and economic independence, while providing revenues that could be used to improve the standard of living of Mexico's large impoverished population.

By 1982, the year that President Lopez Portillo nationalized the banking industry, the state was running 1,155 firms. By this time inflation was rampant. The peso was overvalued. Expectations generated by new oil discoveries in Mexico were not realized. Tension between the private sector and the government rose. Larger segments of the population became disillusioned with the PRI, the ruling party. As real wages plummeted, the threat of social unrest became real.

Mexico's economic policy has shifted course dramatically in the last twelve years. President Salinas announced a new role for the state and an end to Mexico's efforts to maintain economic independence. The selling off of state properties accelerated in the 1980's and by 1991 only 260 firms were still under government control. A small number of Mexican capitalists have been in a position to buy state enterprises, and privatization has inevitably increased the concentration of wealth. Except for the few industries exempt by law from being sold off to private investors, the Mexican president has the power to select the firms to be disposed of, choose the buyers, and to set the terms of sale. It is hardly surprising that billions of dollars in state assets have gone to cronies and supporters of the ruling party. The great majority of state enterprises were disposed of through private bids. Unlike the privatization program in Nicaragua and in some other countries, there was little or no use of public offerings to spread ownership to employees or to small investors.

In many cases bargain basement prices paid for these assets represent an astonishing subsidy to the rich. Carlos Slim, a Mexican financier, along with Southwestern Bell and France Telecom, bought effective control of the Mexican telephone monopoly because the government issued controlling and non-controlling shares in such a way that 5 percent of the total shares bought effective control. Thus a $3.9 billion company that earned well over a billion dollars a year was effectively purchased for $400,000,000. (See Business Week July 22, 1991.) Mr. Slim is reputed to have a personal fortune of $2.9 billion, one of several recently created Mexican billionaires, according to researchers of the Mexican economy in Mexico City. (Mexico, it should be noted, is not unique in selling off state properties at bargain prices. When the Argentine national airline was privatized in 1991 three Boeing 747's were sold off for about $500,000 each, a tenth of their value and an old 707 went for $1.54, according to Excelsior, Mexico City's leading newspaper.)

The privatization program has had a distinctly negative impact on Mexico's severe unemployment problem. Since 1983 more than 400,000 jobs have been lost as a result of privatization, the New York Times reports. In many cases the government cut the workforce before putting state enterprises on the market to enhance their attractiveness to private investors. "The people love to buy when we have already managed the cleanup," as Pedro Aspe, the finance

minister, put it in an interview last year. According to a study published in 1988, about 53 percent of the parastatal firms were taken over by the government because their former owners went bankrupt. Some of these firms were sold back to these same owners after the government had put them in working order. A much larger number were simply closed, adding further to the unemployment problem.

The sale of state companies brought more than $21 billion into the Mexican treasury. Almost all of it went to retire the national debt, and made it possible control inflation, cut interest obligations, and to make some additional funds available for poverty programs. But the sale of major national companies that were run profitably, and others that could have been turned into profitable enterprises under proper management has undermined the government's long-term revenue base. This is particularly true in Mexico's case for two reasons: (1) Tax collection has always been a major problem. (2) Global companies controlled by non-Mexicans now play a major role in crucial sectors of the economy, and the opportunities for tax avoidance by such firms through the use of tax havens and creative accounting are considerable.

Some privatized firms are providing improved service, Aeromexico, for one. But noticeable improvement in Mexico's notoriously unsatisfactory phone service or routine banking operations has yet to occur. At the same time costs of loans for small customers have soared as investors try to recoup their capital as rapidly as possible. The privatization of highways ran into serious problems because the owners charged tolls three times as high as is customary in the United States and the roads were avoided.

The World Bank has cited the Mexican privatization program as a model for other countries. But the negative impacts are clear. The best that can be said for the program is that it eased some of the dire problems in which the Mexican economy was mired in the early 1980's. Whether creating private monopolies in telecommunications, buses, trucks, sugar, lumber, appliance manufacturing, and other key sectors will represent a long-term solution remains to be seen. Encouraging competition is neither a government objective, according to officials themselves, nor is it characteristic of Mexican business culture.

Finally, privatization should be judged for what it is: One critical component of a reform program to open up the Mexican economy in a variety of ways that tend to reinforce each other--deregulation, freer trade, encouragement of foreign investment. The rise in unemployment, malnutrition, and crime that has occurred in the years of reform has been documented in a number of studies. (To take one example, robberies in the Federal District rose from 40,800 in 1981 to 71,000 in 1989. See Nora Lustig, Mexico: The Remaking of an Economy Brookings Institution, 1992, pp. 61-95)

Except for direct effects on employment and concentration of capital, it is not easy to isolate the role privatization alone plays in the deterioration of social services, public health, and economic security in Mexico, but the data suggests that the way privatization has been carried out is having important negative effects on the majority of Mexicans.

Mexico's prosperity is dependent on its prospects for long-term stability. The development choices now being made seriously restrict the government's traditional role in guiding the economy for the common good. The Mexican system needed reform, but the successful experience of Germany, Japan, Korea, and other vigorous economies around the world where government is a major shareholder or owner of leading industries suggests that selling off assets to raise cash is not necessarily the way to achieve stable or sustainable development.

How Mexico or Russia or Spain define the role of government in their respective economies is their business, except where the relationship between public authority and private enterprise constitutes unfair competition. Privatization of mismanaged state enterprises can advance public purposes. But uncritical ideological support for privatization from the United States is not in the national interest where it exacerbates economic and social problems. This is especially true when the country concerned is on our border.

An Assessment of the Russian Privatization Program

Lynn D. Nelson (Virginia Commonwealth University)

Paper prepared for presentation at the hearing, "The Privatization Experience: Strategies and Implications for Small Business Development," Committee on Small Business, United States House of Representatives, Washington, DC, April 14, 1994. The work leading to this report was supported from funds provided by the National Council for Soviet and East European Research, which however is not responsible for the contents or findings of this report.

An Assessment of the Russian Privatization Program

Introduction

` The principal objectives of privatization in Russia, as articluated in state privatization programs of the Russian Federation, are to form a group of private owners who can contribute to economic revitalization, to improve enterprise efficiency, to ensure the availability of a social safety net, to promote financial stabilization, to promote a competitive economic environment, and to attract foreign investment.[1] Beginning in 1993, the priority was to be "people's privatization"--the distribution of state property for vouchers.[2] The State Property Management Committee considered 1993 to be the most critical year for "building a fair people's capitalism." As many people as possible would be involved in voucher auctions for state property.[3] In this paper I evaluate the success of the privatization program in achieving its stated objectives, with particular attention to the privatization of production enterprises.

I began studying economic reform in the Soviet Union when the development of cooperative enterprises was being encouraged, and my principal research focus since the breakup of the USSR has been the Yeltsin government's economic reforms. Since 1992 I have focused intensively on privatization developments in four Russian cities and oblasts that I selected to reflect some of the regional and economic sector diversity of Russia: Moscow, Ekaterinburg (Sverdlovsk oblast), Voronezh and Smolensk. When in Russia, I coordinate the work of a team of Russian field researchers, and during the past two years, we have gathered data related to privatization in each of these cities from a variety of sources,

including public records, published and nonpublished material, interviews with more than 10,000 respondents, and observation of meetings devoted to privatization planning and decisionmaking. We have conducted lengthy interviews with officials, opinion leaders, enterprise directors and workers, and general population samples in each of our research locations. Our work with officials involved in privatization decisionmaking has been carried out at the okrug, city, oblast and federal administrative levels; and we have interviewed enterprise personnel in state, privatizing and privatized enterprises as well as executives of foreign firms, joint ventures and new private businesses. I have received funding for this research from the National Council for Soviet and East European Research, the Center for Institutional Reform and the Informal Sector, the International Research and Exchanges Board (IREX), and Virginia Commonwealth University. The 1993 interviews that are discussed in this paper were conducted from June through August with funding from the National Council for Soviet and East European Research.

Privatization in Russia has been quantitatively impressive. About 70 percent of enterprises that were eligible for privatization under the "small privatization" program have been privatized.[4] By the end of 1993, more than 8,500 enterprises had been included in voucher auctions, and the form of ownership had been changed in enterprises which employed more than 30 percent of Russian industrial workers. These enterprises had either been transformed into joint stock companies or purchased by their personnel.[5] On April 7, 1994, Chubais reported that 105 million citizens had invested their vouchers, and he expressed confidence that the remaining 45 million vouchers would be invested before the middle of June. About 80 percent of the 20,000 eligible large and medium-sized enterprises had by that time been converted into joint stock companies.[6]

These widely-circulated figures mask, however, less positive qualitative features of the Russian privatization initiative. In reality, it was clear by the end of 1993 that voucher privatization was not being embraced where its acceptance was the most pivotal--among enterprise personnel--and that the promise of fair property distribution among the population was not being realized. Inadequacies of the privatization program contributed importantly to the worsening of Russia's economy and to the political conflict of September and October, 1993, which produced the backlash among a substantial number of voters in December.

The Widespread Dissatisfaction
with "People's Privatization

The most striking deficiency of the voucher privatization program is its lack of acceptance among directors and workers in the production enterprises which were supposed to be the objects of voucher privatization. Although the Russian government had decided in 1992 that large production enterprises were to be prime candidates for voucher privatization, a year later it was clear that this expectation was not being realized. Throughout Russia, among those enterprises that had been transformed into joint stock companies by the end of 1993, more than three-fourths had chosen the variant of privatization which allowed workers to own 51 percent of a company's shares from the start, with an opportunity to buy additional shares[7]--thus effectively precluding the possibility of "people's privatization" in those enterprises. Although this outcome was not in keeping with the government's plan, it was entirely consistent with the overall perspectives of the 583 directors and other

enterprise executives we interviewed in 1993 whose perspectives about different privatization options we explored in depth. Only five percent of the directors in our study favored voucher privatization over other alternatives for privatizing large production enterprises. Significantly, our research suggests that, even among privatization officials, the voucher program is not well-regarded. A large number of the 146 officials in property management committees and property funds we interviewed in 1993 described in detail their dissatisfaction with the voucher privatization concept, in both theory and practice. Only 22 percent of the property management committee members in our study favored voucher privatization over other privatization strategies, and property management committees are linked in tight hierarchical administrative structure to the State Property Management committee, whose chairman Anatolii Chubias directs the Russian privatization program. Property fund members were even more skeptical about voucher privatization, with only 12 percent favoring it. The preferred privatization method among these privatization decision-makers would be for enterprise shares to be sold for money, rather than being exchanged for vouchers. Further, among 87 city and oblast officials in our 1993 study (officials who were not members of property management committees or property funds), only 20 percent favored voucher privatization.

In the general population, also, voucher privatization of production enterprises was the choice of only seven percent of our 4,000 respondents in 1993.[8] When we asked the general sample how much the average person was benefiting from the voucher program, only 20 percent said "a great deal" or even "somewhat." An overwhelming 82 percent thought that mafia and crime groups were benefiting, however; and 76 percent believed that current officials were.

Although this report focuses largely on the privatization of production enterprises, it is worth noting that most Russian citizens, including officials

and enterprise personnel, are also dissatisfied, overall, with the results of the "small privatization" effort that had preceded large-scale privatization of production enterprises. Only 34 percent of our general population respondents were even "somewhat satisfied" with the results of privatization in the retail and consumer services spheres, which, at that time, were more than 50 percent privatized.

The Unsatisfied Need for Enterprise Restructuring

It is widely acknowledged that a large proportion of Russian enterprises need to be restructured in order for efficiency to be significantly improved. Yet, the voucher program has not clearly promoted fundamental restructuring within most privatized enterprises. The most obvious internal transformation that has been effected through privatization has been change in formal ownership. Most management teams have remained intact. Most workers have kept their old jobs. At most plants, long-overdue modernization has not begun. Most privatized production enterprises have no foreign investment, and most have not sold shares for much-needed working capital. State ownership has declined, but because of marked inattention to such critical factors for economic development as the maintenance of supply and distribution networks during the transition, severe disruptions have resulted. The burden of coping with skyrocketing inflation has produced a nonpayment-for-goods epidemic and a severe shortage of working capital.

Voucher auctioning has not ensured that outside owners would be brought in, because personnel have themselves been free to purchase shares of their

enterprises with vouchers, and worker ownership of enterprises is the privatization method of choice among the directors and workers in the general population we interviewed in 1993.

Privatization and Economic Revitalization

The exclusion of outside investors might be seen as self-defeating for enterprises if outsiders were offering money in exchange for ownership of shares, but voucher auctions do not bring money to enterprises. Voucher privatization substitutes "worthless paper," as Nizhnii Novgorod's governor Boris Nimtsov put it, for real money in the purchase of enterprise shares. In the production sphere, the need for extensive modernization is acute, and lacking investment capital, any near-term profits that are earned will necessarily be used, in the large majority of enterprises, to improve production. Sometimes, money does change hands through voucher auctioning. But ironically, the exchange does not benefit the enterprise whose shares are acquired in the process. Most of the money has been paid to individual Russian citizens, who sell their voucher for enough to buy perhaps a bottle of vodka or three kilograms of butter, and to speculators who trade in vouchers.

When we asked directors in our 1993 study about their most serious obstacles to increasing productivity and profits, the enormity of this problem became obvious. Directors' most pressing concerns centered around, not supply questions or work force deficiencies, but money. The director of a Voronezh firm which manufactures electrical supplies, told us, "I don't have any money to replace our obsolete and worn-out production equipment. When machines break down, if we can't repair them with parts that are on hand, we just have to stop

using them. And selling what we make doesn't bring in much money, because our buyers often can't pay."

Life goes on with a shortage of electrical supplies, but not without food. The director of a plant that produces canned goods complained to us that his buyers, retail stores, have reduced their orders to a trickle. "Many aren't able to pay for even basic food items now," he said. And at a Moscow factory where more than 1,000 workers make clothing for children and adults, the director noted, "We are working as well as we ever have, and our workers have always been capable, but most of what we make goes to pay taxes. We have no money to upgrade our old equipment or even repair our buildings, and we can't afford the high interest for loans."

Some of the largest enterprises in Russia are in the Urals region. When we interviewed the general director of a huge production facility in Ekaterinburg, he told us that he had originally supported voucher privatization, but he had learned, he said, that voucher distribution had done nothing to make his enterprise more effective. Because of its large size, shares of this enterprise were available throughout Russia for vouchers, and nearly 30 percent of the company's shares were claimed through voucher auction, mostly by outsiders. "But my most acute problem is lack of working capital," the director added, "and vouchers haven't helped me at all in solving that problem, or in dealing with any of my company's other barriers to improved productivity."

Although outside investors who claim enterprise shares for vouchers bring nothing to an enterprise that it needs, their investment represents a claim on the enterprise's profits. It should not be surprising, then, that enterprises resist such "investment," which they often predictably see as only unjustified intrusion.

The Pervading Political Agenda of Russian Privatization

There is a fundamental contradiction between the program's underlying political objectives and its stated economic ones. It was only a matter of time until this contradiction created both a crisis of production and a crisis of political legitimacy.

Although the second aim listed in the 1992 State Program for Privatization was "to increase the productivity of enterprises,"[9] it was clear by the time the Supreme Soviet approved the program that the primary focus of privatization had changed. The government's chief concern had shifted to dismantling the state control system as quickly as possible. Along the way, and in spite of a chorus of warnings and cautions by analysts outside the Yeltsin government's circle of privatization planners, questions about efficiency were largely ignored. The possibility of disruptions during the rapid shift to decentralized planning was now seen as less sinister than the fear that opposition forces might halt the process entirely if given enough time.

In nearly every important detail, the Yeltsin government's privatization program is intended to promote the realization of political more than economic goals. On that point Chubais is clear. When we interviewed him in August 1993, he told us unhesitatingly, "This is not an economics program; it is a political program. It is five percent economics and 95 percent politics." Nor does Chubais hesitate, in addressing colleagues, to make gloomy long-range predictions for the prospects of a very large number of privatizing enterprises. In a July 1993 speech he warned, "The biggest price that we will pay <u>will come tomorrow</u>. The

main danger to the whole privatization program is the risk that it will face when some of the privatized enterprises, or probably most of them, become bankrupt."[10] Before 1993 ended, Chubais's State Property Management Committee was estimating that more than half of all federal property was on the brink of bankruptcy.[11]

Russia's privatization planners inherited a faltering production system, certainly. Their mistake was in not seriously addressing problems of industrial performance and misplaced incentives. The Gaidar-Chubais team established other priorities. Their energies were focused more on destroying the existing command system than on building an improved production system.

The Russian government's privatization program established a process for divesting the state of property without first developing procedures for facilitating the survival of those newly-privatized enterprises in an alien economic environment. Divestment was the simpler of the two tasks, by far. And the second need was not adequately, or even seriously, addressed by the privatization planners. This has been the privatization program's most costly defect, whose negative consequences have already been enormous and threaten to accelerate even further in both the economic and political spheres. The inadequate preparation of Russian enterprises to operate in a market economy--indeed, the manifest inattention to that vital aspect of privatization by the Yeltsin government--may ensure, if uncorrected, that Russia's production system will not recover from its recent precipitous decline in the foreseeable future, and that the Russian political system will not soon establish a stable democratic legislative structure which could check excesses of executive power.

It may not be too late to reverse this mistaken course, and to attend to the requirements of creating a favorable interorganizational context for market

relations, but it is almost too late. Too many enterprises have already been privatized and left, predictably, to flounder, and the economy has already been seriously weakened because of the misplaced priorities of privatization planners. And with the revitalization of nationalist and Communist opposition movements in Russia, Chubais's "tomorrow" has already arrived.

The Equity Issue

The voucher program has been showcased by Boris Yeltsin and his economic planners as the vehicle through which the property accumulated through decades of Soviet rule would be equitably returned to the people. "We don't need a few millionaires," Yeltsin proclaimed after the voucher program was unveiled. "We need millions of owners."[12] And privatization head Chubais emphasized, "The politics of the State Property Management Committee is not to further the stratification of society but to let everyone take part in people-oriented privatization."[13]

Yet, voucher privatization has failed to deliver on its promise of equity. For most Russian citizens, an amount of investment in Russian enterprises that could be meaningful in even a symbolic sense--prominently hailed by Yeltsin and his ministers as voucher privatization's chief feature--is as elusive today as it was under Communist rule. With the new privatization, there is not even a pretense of broad social equity.

Back when voucher privatization was still an idea being discussed by Egor Egor Gaidar's planning team, it was first met with skepticism. Finally, though, they decided that a substantial part, at least, of "the people's property" should be distributed to citizens free of charge. This was a critical

development which had broad implications for the way the privatization effort evolved in 1992 and early 1993. There was also a practical consideration here. With the liberalization of prices in January 1992, savings were largely wiped out, and most people did not have enough money to buy property while at the same time adjusting to rapidly rising prices for necessary expenses. Thus, the Russian reformers ultimately incorporated the concept of free distribution of property to citizens as a keystone of their program,[14] and equity considerations were highlighted as one of the voucher program's key strengths.[15]

But public confidence in the voucher program has been seriously weakened by special regulations which benefit those enterprise personnel who work in the relatively small number of enterprises that are seen as particularly desirable. People who are not employees of those unusually-successful firms are disadvantaged in some conspicuous ways. Securing useful information about the financial prospects of privatizing enterprises has proven to be virtually impossible for the average person, and that problem has nagged potential investors since the beginning of the program.

Information about the competitive potential of privatizing enterprises is not completely lacking. Rather, the kind of information that investors might find useful has not been made public. Many state employees who are involved in privatization have solid data about enterprises which could serve as a basis for judging their relative merits. Those employees are prohibited by law from investing directly in enterprises. They know too much. Unfortunately for the privatization program, a large number of citizens are keenly aware that they know too little about how to successfully navigate the uncharted waters of Russian privatization. Nor does the opportunity to exchange personal vouchers for shares in investment funds offer a promising solution for most of the

millions who have chosen that option. By the end of 1993 more than 600 voucher investment funds were registered in Russia. Together, these funds had attracted more than 51 percent of all the vouchers that had been issued. Fewer than half of these vouchers were invested in privatizing enterprises, however. The others were being held at year's end because of a shortage of investment opportunities that were considered attractive by the funds' managers.[16]

Most investment funds are not paying dividends, because of the difficulties faced by the enterprises where funds have invested the vouchers they purchased. Large numbers of private investors in these funds have become impatient with the funds' inability to pay the expected dividends. By now, many funds have either stopped functioning or are selling large numbers of vouchers at stock exchanges in the hope of being able to make at least a one-time payment to investors. This disappointing outcome was not what voucher recipients had anticipated.[17]

The State Program for Privatization for 1992 stated that "enterprises whose activity is not efficient" were expressly targeted, among others, for "obligatory privatization."[18] The State Property Management Committee complied with this instruction in developing its list of large and middle-sized enterprises slated for obligatory privatization.[19] Speaking about this "obligatory privatization" list, Dmitrii Vasil'ev, vice-chair of the State Property Management Committee, observed, "According to our estimate, the properties of the 4,500 enterprises which are to be privatized in the 'obligatory' category are enough to bring in all the vouchers that have been allocated."[20] (This is not to say that all enterprises on the 'obligatory' list are bad investments. A number of enterprises in several categories included in this list are promising by any measure. Also, enterprises are allowed to voluntarily opt for privatization, except for those in categories that were explicitly or implicitly excluded;[21] and many have.)

A further disadvantage accrues to those who are not employed by the more successful enterprises when they invest their voucher. Because of the manner through which vouchers are distributed at auction, in firms where shares are in high demand among outside investors, a voucher will buy less; because the purchasing power of vouchers is dependent on demand. But the purchasing power of vouchers used by an enterprise's workers is not subject to the fluctuating value of vouchers for other investors. Enterprise assessments which determine the price of shares to enterprise personnel are based on January 1992 prices.[22] The result is that outside investors who want to purchase shares of an attractive privatizing enterprise have to pay the much higher market prices for shares that are in high demand. "To each according to his employment," thus has become an operative principle in the new Russia. But only 12 percent of the population work in large industrial enterprise, and only a few of those are considered good investments--perhaps only about one-tenth.[23]

Even those enterprises that survive privatization and the difficulties of establishing market relations in a chaotic economic environment will not, for the most part, soon be able to pay any dividends to outside shareholders. There are additional reasons why most shareholders should not expect any return on their investment in the foreseeable future. Privatized Russian enterprises do not face the constraint of shareholder discontent that typifies public companies in the West. Because voucher privatization gives no working capital to enterprises, privatized firms neither have a financial obligation to shareholders nor an incentive to provide dividends to stimulate further investment.

Principal Beneficiaries
of Russian Privatization

Some groups inside Russia have benefited substantially by the direction of Russian privatization under Chubais's leadership. A number of powerful financial groups have acquired enterprise shares through voucher speculation. Individuals who had liquid assets that were available for investment following price liberalization in January 1992, and there were not many, have been presented with extraordinary opportunities. Many members of the old Communist Party nomenklatura have taken advantage of their positions and power in this time of economic chaos to secure valuable assets for themselves and their associates, and many local officials have also broadened their power in privatization decision-making. A number of enterprise directors have found themselves strategically placed to transfer the control of state property into their own hands. Russians with an entrepreneurial spirit but lacking nomenklatura connections or large sums of money (money often illegally gained) have had less success. New business startups have been disappointingly few since the beginning of the privatization program, however, and governmental inattention to this critical area has been conspicuous during most the the period since late 1991. Russia's production system, once mighty, has been severely weakened. By the end of 1993, production had declined to 59 percent of its 1990 level,[24] and the severity of economic hardship being endured by Russia's population had been well-documented. The lives of most Russian people have worsened dramatically since 1991, and public opinion research shows that most are fully aware that the promised "social safety net" has not been provided.[25]

The hardship experienced by Russia's citizens has spawned ultranationalist backlash and put at risk fundamental social and cultural institutions. Anti-

Western, especially anti-American, sentiment has spread rapidly. This sharp turn in public opinion has been fed by both ultranationalism and a large number of mass media analyses in prominent Russian newspapers and journals which suggest a direct link between the economic and military interests of foreign governments and firms, on the one hand, and the rapid deterioration of Russia's economy, on the other. Finally, recent political developments and the continuing vitality of key elements of the command system demonstrate unambiguously that a point of "irreversibility" of reforms, which has been a prominent justification for dysfunctionally rapid privatization, has not been reached. The new privatization program which was approved by a Yeltsin decree on December 24, 1993, for example, gives branch ministries even more control over enterprises than had been the case earlier.[26]

United States Government Policy and Russian Privatization

US government officials have offered consistent and highly visible public support for Russia's economic reforms since the breakup of the Soviet Union, and they have repeatedly encouraged the privatization initiative under Chubais's direction. Further, a number of advisers to the Russian government are widely viewed in Russia as representing United States interests.

Particularly strong support has been offered by both US government officials and several advisers for aspects of Russia's economic program which have resulted in severe economic problems and which have contributed to Russia's precipitous productivity decline. Especially prominent in this regard have been unqualified support for the Russian government's emphasis on a rapid pace for

privatization, and generally uncritical acceptance of macroeconomic stabilization measures, to the neglect of negative economic and social consequences of this strategy, at least before Russia's elections in December 1992.

The principal policy implication of this analysis for the government of the United States is that policymakers who study Russian privatization should quickly move beyond an inadequate emphasis on the pace of privatization, which neglects both political and organizational factors that could create a stable foundation for market relations among newly privatized enterprises. Whether the subject is privatization, or Stalin's collectivization that privatization is intended to correct, or Khrushchev's hurry-up agricultural programs, the responsiveness of a Soviet-style command system to blueprints for change from the center has repeatedly been demonstrated. Russia's administrative system has repeatedly proven itself fully capable of implementing both very rapid and entirely misdirected change initiatives. If Russia's unprecedented opportunity for both economic and political development is to be effectively realized, handed-down decisions which are insensitive to the actual situations of Russia's people and institutions must give way to a different organizational approach.

The literature which has been generated on the subject of recent economic reform in Eastern Europe provides no adequate evidence that constructive economic reform had to trigger the precipitous declines in production, research and development support, and economic well-being among the population that Russia has known since the onset of the Yeltsin-Gaidar economic reforms. I am confident that the economic approach strongly advocated for Russia by prominent Western advisers and uncritically endorsed in public statements of US government officials will be judged by future analysts as having been profoundly

deficient.[27] But now, Russia must cope, not with the interpretations of history about the country's economic experiment,[28] but with the privatization program's crippling results. Russian leaders must account to the many citizens who were sold privatization as payment for the privation brought on by Communism, and who are now questioning their country's faulty approach to economic reform. The United States, having unhesitatingly supported some of the most flawed elements of the Yeltsin government's economic program, is now implicated in the reform initiative's negative economic and political impact. A decision to abandon this ineffectual policy course is overdue.

Notes

[1]"Gosudarstvennaia programma privatizatsii gosudarstvennykh i munitsipal'nykh predpriiatii v Rossiiskoi Federatsii na 1992 god," Ekonomicheskaia gazeta, no. 29 (July 1992), 15-18.

[2]"O poriadke vvedeniia v deistvie sistemy privatizatsionnykh chekov v Rossiiskoi Federatsii," Ekonomika i zhizn', no. 31 (August 1992), 18. These government regulations were approved by a Yeltsin decree dated August 14 ("O vvedenii v deistvie sistemy privatizatsionnykh chekov v Rossiiskoi Federatsii," Kommersant, no. 34 (17-24 August 1992), 24.

[3]Leonid Mikhailov, "Ot bednogo sotsializma -- k bednomu kapitalizmu," Nezavisimaia gazeta, no. 233 (3 December 1992), 2.

[4]Boris Krotkov, "Anatolii Chubais o perspektivakh privatizatsii--94," Delovoi mir, no. 267, (31 December 1993), 1; Igor' Karpenko, "V strane uzhe 55 millionov chastnykh sobstvennikov," Izvestiia, no. 251 (30 December 1993), 2.

[5]"Goskomimushchestvo prognoziruet vsplesk delovoi aktivnosti na chekovykh auktsionakh," Moskovskie novosti, no. 8 (20-27 February 1994), 2B.

[6]These totals include privatization through April 4. Keith Bush, "Report on Privatization," RFE/RL Daily Report, no. 67 (8 April 1994).

[7]"O sotsial'no-ekonomicheskom polozhenii Rossii v 1993 godu (po materialam Goskomstata Rossii)," Ekonomika i zhizn', no. 6 (February 1994), 8.

[8]We interviewed 1,000 people in each of our four research cities. These probability samples were randomly selected from address bureau lists (Moscow and Ekaterinburg) and voucher registry lists (Voronezh and Smolensk).

[9]"Gosudarstvennaia programma privatizatsii gosudarstvennykh i munitsipal'nykh predpriiatii v Rossiiskoi Federatsii na 1992 god," 15-18.

[10]Anatolii Chubais, "Remarks Delivered by Vice-Premier Anatolii Chubais at

the International Institute for Applied Systems Analysis, July 9, 1993" (mimeo). Emphasis added.

[11]Elena Kotel'nikova, "Viktor Chernomyrdin sdelal stavku na Goskomimushchestvo," Kommersant-Daily, no. 185 (28 September 1993), 2.

[12]Aleksandr Borisov, ". . . plius sploshnaia vaucherizatsiia vsei strany," Megalolis-Express, no. 35 (2 September 1992), 3.

[13]Anatolii Velednitskii, "Priblizhaetsia delezhka. Gosimushchestva," Delovoi mir, no. 110 (10 June 1992), 1.

[14]See Oleg Bogomolov, "Razdaetsia nicheinoe bogatstvo," Nezavisimaia gazeta, no. 13 (23 January 1993), 4.

[15]See, for example, World Bank, Russian Economic Reform: Crossing the Threshold of Structural Change (Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank, 1992), 88-89.

[16]See Elena Kotel'nikova, "Goskomimushchestvo stimuliruet chekovye fondy," Kommersant-daily, no. 237 (9 December 1993), 3.

[17]See, for example, Viktor Smirnov and Viktor Ivanov, "Provintsial'nye chekovye fondy ispytyvaiut krizic," Kommersant-Daily, no. 7 (19 January 1994), 2.

[18]"Gosydarstvennaia programma privatizatsii gosudarstvennykh i munitsipal'nykh predpriiatii v Rossiiskoi Federatsii na 1992 god," Ekonomika i zhizn', no. 29 (July 1992), 15.

[19]Dmitrii Vasil'ev, "1 oktiabria--nachalo privatizatsii v Rossii. Dlia kogo? Chto nuzhno sdelat' k etomu sroku?" Izvestiia, no. 214 (25 September 1992), 2.

[20]Dmitrii Vasil'ev, "Privatizatsiia: voprocy i otvety," Izvestiia, no. 224 (9 October 1992), 2.

[21]In some categories, enterprises needed to apply for permission to

privatize.

[22]Enterprises have been reassessed since January 1992, but Yeltsin's July 6, 1993 decree On Additional Measures to Secure Rights of Russian Citizens Participating in Privatization guaranteed that enterprise reassessment after January 1992 would not affect the prices of enterprise shares for workers and voucher auctions.

[23]Vasilii Seliunin, "Tret'ia popytka," Izvestiia, no. 211 (22 September 1992), 1, 3.

[24]Andrei Illarionov, "Katastroficheskogo spada net, no mif o nem sokhraniaetsia," Finansovye izvestiia, no. 6 (10-16 February 1994), 2.

[25]Mezhdistsiplinarnyi akademicheskii tsentr sotsial'nykh nauk, Ekonomicheskie i sotsial'nye peremeny, no. 1 (January 1994), 24.

[26]See "O Gosudarstvennoi programme privatizatsii gosudarstvennykh i munitsipal'nykh predpriiatii v Rossiiskoi Federatsii," and "Gosudarstvennaia programma privatizatsii gosudarstvennykh i munitsipal'nykh predpriiatii v Rossiiskoi Federatsii," Ekonomika i zhizn', no. 2 (January 1994), 1, 4-10.

[27]For further elaboration of this point see Lynn D. Nelson and Irina Y. Kuzes, Property to the People: The Struggle for Radical Economic Reform in Russia (Armonk, N.Y.: M.E. Sharpe, 1994), 38-44. See also Peter J. Stavrakis, "State Building in Post-Soviet Russia: The Chicago Boys and the Decline of Administrative Capacity," occasional paper no. 254 (August 1993), Kennan Institute for Advanced Russian Studies, Washington, D.C.

[28]Or, as Aslund and Sachs characterize it, Russia's "partial experiment." I suggest, however, that more stringent shock therapy would only have exacerbated Russia's slide toward economic chaos and political extremism. We know of no evidence that would effectively contradict this view. Their frequent mention of the experience of other East European countries is not persuasive.

Testimony

Daniel M. Singer, on behalf of the
Central and East European Law Initiative (CEELI)
of the American Bar Association
before the House Committee on Small Business
April 14, 1994

Mr. Chairman, and members of the Small Business Committee of the U.S. House of Representatives. My name is Daniel Singer. I am a lawyer and am Of Counsel to the law firm Fried, Frank, Harris Shriver & Jacobson. I joined the Washington office of the firm in 1958 as a young associate, became a partner in 1965, and retired and became Of Counsel in 1987. I still have an office at the firm.

While in active private practice, I was the chairman of the firm's real estate department in the Washington Office where the bulk of my practice was transactional (rather than litigating or lobbying or counseling). I was the lead lawyer in Washington for the Italian group that developed the Watergate Project and was the architect of its legal structure. I was also the lawyer for the developers of several large regional enclosed mall shopping centers, including Springfield Mall. I have also been involved in many different kinds of commercial and housing developments in the Washington area.

I appear here today representing the Central and East European Law Initiative ("CEELI") of the American Bar Association.

The Central and East European Law Initiative is a public service project of the American Bar Association (ABA) designed to advance the rule of law in the world by supporting the law reform process underway in Central and Eastern

Europe and the New Independent States of the former Soviet Union (NIS). Through various programs, CEELI makes available U.S. legal expertise and assistance to emerging democracies that are in the process of modifying or restructuring their laws or legal systems.

A premise of this project is that lasting economic and political reform is dependent on a functioning system of law. The rule of law, so basic a part of our cultural fabric, is an urgent priority and new phenomenon in many countries now moving away from communist and socialist systems. In these countries, political reform and economic reform are plainly dependent on one another, and to endure both require the underpinnings of a sound legal structure.

In seeking to play a role in this essential law reform process, CEELI has been guided by three principles. First, CEELI is designed to be responsive to the needs and priorities of the countries of Central and Eastern Europe and the NIS, not those of the U.S. participants or sponsors. Accordingly, the structure of CEELI was heavily influenced by early consultations with government and non-government officials, legal scholars, and practitioners in Central and Eastern Europe and the NIS. CEELI workshops and other programs have been in direct response to requests from those involved in law reform in Central and Eastern Europe and the NIS and have thus focused on priority issues such as constitutional law, creation of an independent judiciary, and criminal law reform.

Second, the design of CEELI recognizes that U.S. legal experience and traditions offer but one approach that participating countries may wish to consider. A variety of models, including those of many civil law countries, offer alternative legal traditions that are also valuable sources of law. In the emerging democracies

of Central Europe and the NIS there is, however, great interest in the U.S. legal experience, particularly with regard to individual and human rights, allocations of governmental power, and the free market system.

Third, CEELI is a public service project, not a device for developing business opportunities. Accordingly, CEELI has adopted specific conflict of interest guidelines designed to assure that technical advice offered by CEELI participants is neutral and that conflicts of interest or appearance of conflicts are avoided to the maximum extent possible.

By turning to its own membership of 374,000 lawyers, as well as other legal experts in the United States and elsewhere, CEELI has been able to marshal and make available a high level of expertise in the areas in which the participating countries have requested assistance. Because the lawyers and judges who participate volunteer their time on a pro bono basis, because host countries have agreed to cover certain local costs, CEELI has been able to achieve an extraordinary degree of leverage, maximizing the program activities per dollar of financial support.

Utilizing a variety of formats, CEELI has initiated a number of different programs. Each is designed to respond to the type of need identified and to offer continuing and practical assistance. Other program initiatives are planned and will begin once funding for them and necessary support staff become available.

TECHNICAL ASSISTANCE WORKSHOPS CEELI has responded to a number of requests for technical assistance workshops. Held in the requesting country, workshops typically focus on a particular substantive area of the law and

involve the participation of four to six experienced lawyers or judges, usually including one from a civil law country. Workshops, which are usually one week in length, facilitate extended dialogue among participants, discussion of legal traditions of various countries, presentation of case studies, assistance in drafting, and systematic follow-up. Comments on the effectiveness of these workshops appear below.

LEGAL ASSESSMENTS/CONCEPT PAPERS The urgency of several requests for assistance has precluded planning full workshops. In such instances, CEELI has offered immediate assistance by circulating draft legislation within the United States for comment. By relying primarily on ABA Sections with appropriate expertise, CEELI has been able to provide expert assessment of more than 160 draft laws, including those addressing such key issues as antitrust, tax, foreign investment, criminal law, and land use, as well as the constitutions of Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Kazakhstan, Kyrgystan, Lithuania, Moldova, Poland, Romania, Russia, Ukraine and Uzbekistan.

Concept papers identify and discuss primary issues of law prior to the drafting process. The papers set forth alternative solutions to the issues raised and provide information regarding current trends in the law.

RESIDENT LIAISONS AND SPECIALISTS CEELI provides lawyer liaisons who reside in the host country for a period of six months to one year. These liaisons work with the host country to identify legal reform priorities and coordinate CEELI's assistance. CEELI has liaisons currently stationed in Albania, Armenia, Belarus, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Poland, Romania, Russia,

Slovakia and Ukraine. In response to requests for access to resources on a longer-term basis, CEELI provides U.S. legal experts for extended visits. Legal specialists have provided long-term assistance in Albania, Bulgaria, the Czech Republic, Estonia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, Romania, Russia, and Ukraine on a variety of subjects including constitutional drafting, court administration, foreign investment, white collar crime, legislative procedure, and local government.

SISTER LAW SCHOOLS Under CEELI's Sister Law School program, each law school in Central and Eastern Europe has been paired with at least three American law schools with which they will work on a continuing basis. Workshops in Poland and the former Yugoslavia and a September, 1991 visit of nearly 20 East European law deans set the foundation of this program, which include exchanges of faculty and students, joint research projects, and assistance in library development, curriculum reform, and law school administration. To date, 140 U.S. and 47 Central and East European law schools have participated in the Program. The program expanded to the NIS in September, 1993.

LEGAL TRAINING CEELI offers lawyers, judges, and law school faculty training in the continuing development and understanding of new legal infrastructures. CEELI also places young East European faculty members with law faculty "mentors" in their U.S. sister law schools for six month internships.

CEELI expresses its appreciation to the following organizations for the financial support they have generously provided to this project: National Endowment for Democracy, United States Agency for International Development, United States Information Agency, Section of International Law and Practice of

78-333 O - 94 - 5

the American Bar Association, International Academy of Trial Lawyers and the American Bar Association.

In June 1993, on behalf of CEELI, I went to Poland as a legal specialist. Because of my experience as a real estate lawyer, I was assigned to the Poznan regional office of the Agencja Wlasnosci Rolnej Skarbu Panstwa, the state agency established in 1990 to take possession of the state farms, to operate them, and, in an orderly fashion, to turn them over to private ownership. . As a product of the streets of New York City, I certainly was not going to be of much help in operating the farms; I barely know one end of a cow from the other. My role was to figure out how to privatize the state farms. Although my experience with privatization as defined in these hearings is minimal and confined to my recent experiences in Poland, my active, hands-on experience lawyering for private entrepreneurs in the private (or mixed public-private) sector is extensive. Perhaps the major lesson I have absorbed over the years is that the availability of affordable financing is essential to liberating the energies of entrepreneurial risk takers for development activity. These are the men and women who are willing to suffer the risk of losing it all -- of going bankrupt -- in the hope of making very big profits if they are successful. In the calculus of the marketplace, the risks for real estate developers are very high, and one should not resent the fact that those who are successful get wealthy -- and inspire others to follow in their footsteps.

Poznan is a city of 600,000 people, the fifth largest in Poland and a regional trading center. In the Poznan area, the unemployment rate is under 5%. By contrast, in Lodz and Krakow, that rate is well in excess of 20%. And the Polish national average unemployment rate is over 16%. One of every three persons in

Poznan owns a private automobile. People there have good jobs at good wages and are supporting a wide range of profitable, overwhelmingly private economic activity. They thus constitute a large, eager and qualified pool of potential home buyers.

At the northern end of the city is the state farm of Naramowice, with immediate access to municipal utility services, with good road and tram facilities, and plenty of land on the periphery not now in intense agricultural use. Twenty kilometers southeast of Poznan in Kornik there is a state farm similar to but smaller than the farm at Naramowice, again with excellent infrastructure and municipal road and bus service immediately available. And also with surplus land.

My four-month stay in Poznan last summer was climaxed by a conference at Czerniejwo, a palace owned by the Agencja. Attending the Czerniejwo conference were, in addition to local and national Agencja leaders: the Mayor of Poznan; the governor of the region; the US Consul General in Poznan; leading Polish bankers, including the chief lending officer of the Polish American Mortgage Bank; representatives of several AID-funded organizations one of which was promoting mortgage and collateral security law reform and another of which was promoting the sale of US-manufactured housing. Also on hand were an assortment of architects, contractors, and home builders/developers, as well as TV and print media..

The Poznan regional Director of the Agencja announced at the conference that he had been authorized to participate in public-private joint ventures to which the Agencja would contribute in the aggregate up to 300 hectares (about 750

acres) of its farmland at Naramowice and Kornik for residential development ventures. The single-family homes to be constructed on the land would contain not to exceed about 1500 sq. ft. and would sell for about $75,000. The venture would pay the Agencja for the land only from the proceeds received at the closing of the sales of finished homes to individual home buyers. It was also contemplated that the Agencja would receive, in addition, a share of the venture's overall profit.

Since my return to the US in October 1993, I have been trying to stitch together the components of the development team and otherwise to keep the project in motion. The most critical need was for mortgage financing (both construction and permanent), and then equity capital had to be found. As to the former, there was operating in Poland the Polish-American Mortgage Bank (PAMBank), an entity funded through the Polish American Enterprise Fund (PAEF), the European Bank for Reconstruction and Development, and others. PAMBank made only dollar-denominated loans, so that the borrower bore the exchange rate risk, not trivial with inflation running in excess of 30% per annum. But PAMBank was interested in the Poznan project, had money to lend and had some underwriting experience as well.

One possible source of equity investment appeared as a fortuitous accident of timing. In late 1993, the PAEF (funded by Congressional appropriation of $240,000,000 in 1990-1991 and an additional $100,000,000 of private capital in 1992) was looking to expand its new business opportunities to include investments in residential real estate. PAEF is establishing an affiliate that will furnish up to 70% of the project costs in excess of the construction mortgage funding -- generally, the amounts needed for off-site infrastructure (roads, sewers,

utilities), model homes, marketing surveys and the like. The balance of the required equity will very likely come from the other Polish and American participants -- e.g., the builder/developer, general contractor, and architect.

Negotiations over the structure of the development venture are proceeding now in Poland between the PAEF affiliate, the PAMBank, and potential American and Polish developer partners. The parties are familiarizing themselves with the local municipal requirements. A more detailed presentation to the Agencja is contemplated concerning the selection of a particular 25-acre site for the first 100 homes. Land appraisals and marketing surveys should shortly be underway. And, with uncommon good luck, it is possible that a third of the first 100 new homes will be under construction late in 1994, for delivery in 1995.

Since no one has yet stuck a shovel in the ground, and no loan funds have been advanced, and no sales contracts have been executed, the whole effort may well come to naught. But at this point in time the various participants are clearly serious. Perhaps the best evidence of that determination is that the PAEF affiliate has engaged the Warsaw office of the New York law firm of White & Case; in addition to using its own in-house staff attorneys, PAMBank has retained the Warsaw office of another large New York firm, Weil, Gotshal & Manges; and the American developer group presently under consideration has engaged one of Poland's most distinguished law firms to assist it in negotiating the terms of the joint venture. It is anticipated that, when the time comes, the Agencja will be represented by its regional general counsel, assisted by me, if requested. I am prepared to return to Poland to help negotiate the venture agreements; I have already returned once for a week-long stint of meetings to assure that the various real and possible players were maintaining their interest and commitment to the

project. Even if the venture fails to mature, I hope I will have shown my Polish interlocutors how proactive American-style lawyering really works in the service of client needs, the client in this case being the Agencja.

It should be noted that, from a macroeconomic perspective, home-building is a labor intensive activity, creating many jobs at the jobsite and, in addition, generating demand for the wide variety of stuff that goes into a house -- nails and screws, appliances, furniture, rugs and drapes, and so forth. Most of those business will be small businesses. New construction will augment the municipal tax base of Poznan. And the new residents will be voters and will be buying clothes, food and automobiles in their new local communities.

The hope is not only that the project will be successful for 100 houses in Poznan. The longer range goal is to build about 2500 houses in the Poznan area, and to use the Poznan experience as a model for land privatization throughout Poland. As inflation declines (early in 1994 it was running at an annual rate of about 27%, down from about 35% a year earlier), it is likely that other sources of mortgage money will become available -- especially a World Bank pool totaling about one half billion dollars. Mortgages from that pool are indexed in a complex fashion that discourages a rational borrower in a high inflation economy.

Whatever the outcome of the particular development ventures in Poznan, it is clear that the special skills provided by the CEELI volunteers have broadened the options under active consideration in the privatization process in Poland, including the options open to small businesses.

Thank you, Mr. Chairman, for the opportunity to appear before you today.

Committee on Small Business
House of Representatives

Hearing on

"U.S. Foreign Policy on Privatization:
Objectives and Results for Small Business"

Prepared Statement of
James A. Waddell
Price Waterhouse

April 14, 1994

My name is James A. Waddell. I am a Partner in Price Waterhouse's Office of Government Services, where I also serve as the Executive Director of the International Privatization Group. This group has conducted privatization programs in over forty countries in all regions of the world and has participated in transactions using various privatization techniques. By far the largest funding source for this activity has been the United States Agency for International Development. My time is fully dedicated to a USAID-financed program entitled, "Privatization and Development," and other related projects. A more detailed description of my background is attached.

I have been asked to contribute to the hearing this morning by reviewing the major approaches to privatization that have been used, the benefits and drawbacks of each approach, the conditions under which different approaches have been successful, future trends in privatization programs, and generally commenting on whether the approaches lead to equitable outcomes in the privatization process.

<u>What is Privatization?</u>

Privatization is the process of transferring productive operations and assets from the public sector to the private sector. Broadly defined in this fashion, privatization is much more than selling an enterprise to the highest bidder, as it includes contracting out, leasing, private sector financing of infrastructure projects, liquidation, mass privatization, etc. My testimony will argue that there is no single "best" approach to privatization; the appropriate privatization path depends on the goals that the government is seeking to attain, the individual circumstances facing the enterprise and the economic and political context of the country.

It should be noted that privatization is fundamentally a political process as well as a commercial and economic process. Privatization changes the distribution of power within a society, as it diminishes control of the economy by the state and government-appointed managers. Workers often feel threatened by the potential changes inherent in privatization, although employees frequently benefit from the process. As a result, public support is a major consideration in any privatization program and many of the choices made in designing and implementing transactions reflect the need for such support. Two consequences flow from this factor: 1) choices of approaches are sometimes altered due to "political" considerations, meaning that equity must be promoted in the privatization strategy, and 2) program implementation must be objective and fair to avoid adverse publicity.

<u>What are the goals of privatization?</u>

Many, varied goals are often pursued through privatization programs. These goals often fall along two principal dimensions: 1) broad social or macroeconomic goals, and 2) enterprise specific or microeconomic goals.

Macroeconomic goals are numerous. Fundamentally, privatization is advocated as a means to reduce the government's role in the economy, partly as a philosophical matter (as in the UK) but principally because governments have performed badly in that role. Many countries can attribute

substantial portions of their external debt to liabilities of state-owned enterprises and significant portions of government budgets are devoted to paying subsidies or otherwise assisting loss-making State-owned enterprises. Government's objectives in these situations is often simply to extricate themselves from these financial commitments, and focus scarce resources instead on education, infrastructure, and social welfare.

A second macroeconomic goal of privatization is to promote the development of the private sector by "levelling the playing field" and ending subsidized competition from state-owned enterprises. There is a danger in some countries that emerging private businesses face unfair competition from state enterprises that have access to credit and other inputs at below market rates and better access to government distribution channels. In order to give the private sector a fair opportunity to compete and thrive, state-owned enterprises are privatized.

A third goal of privatization is to obtain the sales proceeds and use them to finance shortfalls in the government's budget or retire some of the public sector debt. While it is widely recognized that focusing on sales proceeds may be short-sighted and ignore other important outcomes of privatization, it is a fact that many governments are strongly influenced by the availability of funds from privatization.

A fourth goal is to broaden share ownership so that the public has mechanisms for saving money and participating in the economies of their countries.

The microeconomic goals of privatization focus mostly on the potential improvements that private sector operators will bring to an enterprise to improve it's performance and increase it's chances of survival. These goals recognize the need to improve enterprise efficiency by introducing new technology and financing sources, improving the quality of the product, enhancing marketing--especially in the international market, providing information systems, and generally improving the management of the enterprise. Obviously successful changes of this nature, when applied to a number of individual enterprises, will have significant macroeconomic implications as well.

A final comment on the goals of privatization is to note that in most countries privatization is but one part of a broad program of structural reform. This is most evident in former Communist countries, where privatization is an element of the process of developing a market economy and its associated financial institutions. In such cases, the privatization program designed should take into account the broader economic goals that are being pursued, as well as the goals specific to the enterprise.

<u>What types of privatization techniques can be used?</u>

There are a variety of techniques that can be selected to use in privatizing state-owned enterprises of activities. These techniques include the following:

- <u>Small business auctions</u>--A normal procedure for privatizing small businesses is to auction them to the highest bidder. Especially when dealing with truly small businesses, such as

- Small business auctions--A normal procedure for privatizing small businesses is to auction them to the highest bidder. Especially when dealing with truly small businesses, such as sole proprietorships and small partnerships, it is advantageous to sell to a single bidder. Given the size of the enterprises, elaborate bid evaluations and valuations are not appropriate and will only serve to delay the process. Auctions also create a dramatic setting to promote the visibility of privatization and allow for broad participation, and they are truly transparent, in the sense that all participants can see for themselves how the process was conducted and identify the high bidder.

  Auctions are generally not appropriate for larger enterprises because the bids will not be as readily comparable: the quality of the new ownership group becomes important--what technology will it bring, is it well-financed, what investments will it commit to making, where will it market the product, will it close the business to limit competition, etc?

- Trade sales to strategic investors--Larger enterprises are often sold on a case-by-case basis, by soliciting technically and financially capable investors to acquire the enterprise. In soliciting the investors, the seller normally conducts a thorough review of the business and prepares material describing the business and it's equipment, workforce, financial condition, markets, and prospects. This information is circulated to a group of candidate investors that express initial interest in the business. These investors then submit bids outlining the terms under which they would purchase shares of the enterprise. The offers will discuss the percentage of shares to be purchased, what debts will be assumed, future investment plans and the financing associated with the expansion, any anticipated changes to the underlying business or the workforce, actions required by the government (sometimes requesting measures such as tariff protection), and other significant factors. Because bids received in this fashion are not readily comparable, the seller must prepare a valuation of the enterprise and the bids received, analyze the strengths and weaknesses of the bidding groups, and then engage in a significant amount of negotiation with the highest ranked bidder. This process is often lengthy, as there are significant but difficult issues at stake.

  Trade sales have significant disadvantages in that they can take a long period of time and substantial expense to conduct. Because of the substantial amount of negotiation often involved, they also have the aura of "back room deals" being conducted and are susceptible to complaints from bidders that the decision process was unfair--particularly when the bids are structured very differently.

- Initial Public Offerings (IPOs)--Initial Public Offerings are the sale of shares directly to the public. Most of the privatizations conducted in the United Kingdom during the 1980's were done through IPOs. Because the potential buying public includes a large number of unsophisticated investors, relatively more information and higher quality information needs to be prepared to conduct an IPO. A valuation of the enterprise is prepared and a pricing strategy is developed that reflects the valuation, but seeks to ensure that the offer is sufficiently attractive that the shares available can be sold. IPOs have the virtue of

stimulating interest among the general public in financial markets and increasing share ownership in society. They are also less subject to negotiated agreements than trade sales, although the negotiations between the selling government and it's agent, the underwriter, may be elaborate.

The disadvantages of IPOs are that they do not bring new capital to the enterprise and do not bring in new managerial talent or resources. As a result, IPOs should only be used if the performance of existing management is satisfactory. In addition, IPOs are very time-consuming and expensive to conduct, and they generally require the existence of a formal stock exchange and broker network or other distribution mechanism to be implemented effectively.

- Joint Ventures--A common form of privatization in some parts of the world--especially China--is the joint venture. Under a typical joint venture, an investor approaches the government and offers to contribute something of value to an enterprise, such as capital, management, or technology, and in return receives a share of the ownership of the newly constituted business. Joint ventures are often attractive to governments that are not fully supportive of privatization because the government does not relinquish all control of the enterprise. Over time, and with new investments, it may be possible to minimize government control by diluting it's ownership interest.

  There are several significant disadvantages to joint ventures as a form of privatization. Because of the government's continued involvement, many of the goals of privatization set forth at the outset of my testimony are not met: the government remains involved in management and it's liability for poor performance is retained. In addition, joint ventures are subject to the same complaints about lack of transparency and participation as trade sales--sometimes even more so due to the fact that joint ventures are often proposed by the investor on an exclusive basis and are less subject to standardization than trade sales.

- Mass Privatization Programs--One of the significant innovations in privatization techniques during the last few years is the development of mass privatization programs. In concept, mass privatization programs avoid the time and expense of case-by-case transactions and involve the general public by distributing shares for free or in exchange for specially created privatization vouchers. The mechanics of mass privatization programs are similar to IPOs, except that vouchers are used to purchase shares, rather than cash. As a result, significantly less analytical time is required and disclosure requirements are greatly reduced. The virtues of a speedy process, which I discuss in the next section, cannot be overestimated, particularly in the transitional economies of the former Communist world.

  The disadvantages of the mass privatization programs lie principally in the diffusion of ownership across broad groups and in the critical role that management is able to play in the privatization process. It is argued that subsequent restructuring of enterprises will be more difficult due to these factors. Offsetting this argument to some degree is the fact that potential investors in these enterprises can negotiate with the new owners--rather

than the government--and can make investments into the enterprise in return for shares, rather than have their funds go into the state treasury. Both of these factors are valued by investors.

- Build-Own-Operate/Build-Own-Transfer Programs--Governments facing severe needs for infrastructure investments increasingly turn to the private sector to finance, build, and operate the needed facilities. In return, the government gives certain assurances to the investor and pays fees for the services provided. This technique has proved useful in attracting additional capital into infrastructure investments and alleviating critical shortages of power and transportation, especially in Asia.

  The disadvantages of these programs are that they are often very difficult and time-consuming to negotiate and structure. Because these programs are relatively new and involve financing of new projects--not assets that are already existing--many difficult issues emerge that have not previously been confronted.

- Liquidation--State-owned enterprises with very limited prospects for survival are sometimes liquidated and their assets auctioned to the private sector. Sometimes these "liquidated" enterprises continue as going concerns; in other cases their assets are sold separately. Liquidation ends the government's commitment to support an enterprise and lays the groundwork for private sector investment--if the product has a market and it can be manufactured efficiently.

  Liquidation is normally a last resort, used when the government has no realistic alternatives. In this sense, it is applicable only in a limited set of circumstances.

In practice, many transactions do not fit neatly into these defined categories. As an example of transactions that are structured along more complicated lines, consider the pattern of telecommunications transactions that has emerged over the last five years. In most of these transactions the government initially sells a minority of shares to a qualified international operator through negotiated trades sales. The evaluation criteria for this bid depend on the purchase price and on the commitment of the operator to expand service coverage and quality significantly. Following one or more years of performance and improvements by the operator, the balance of the government's shares are sold through several rounds of public offerings, involving both domestic and international shareholders.

What is the process of privatization?

Regardless of the privatization technique that is selected, the process of privatization is relatively standardized. Governments generally follow several steps in privatizing enterprises. First, the target companies are reviewed to understand, in a very general way, their characteristics, markets, and prospects. Second, a privatization plan is prepared to guide the implementation. This plan should match the goals of the government and the characteristics of the enterprise(s) to determine the approach that will be taken. Third, the company is marketed, whether to core

investors or the public, depending on the path chosen. Fourth, if necessary, the terms of the transaction are negotiated and the legal documentation prepared. Finally, the transaction is closed.

Throughout this process, several factors are critically important to the success of the privatization program. First, speed is absolutely essential. During the period that governments are deciding to privatize, until the point that new owners are recognized, the enterprise is essentially under control of it's management. Few true ownership interests are represented and the interests of capital--whether of maintaining existing capital or investing new capital--are ignored. Great potential exists for asset-stripping or other misappropriation of assets. In our experience, enterprises lose a substantial part of their value during this period. Speed in the privatization process is critical to ensure that any ownership vacuum is minimized.

Second, the transparency of the privatization process must be preserved and publicized. Any questionable ethical conduct has the potential to destroy the integrity of the process and erode political support.

Finally, the privatization program must be implemented professionally. If it is not, the enterprises, investors, and the public could be discouraged from participating--with disastrous consequences.

What developments in privatization are taking place around the world?

Privatization is moving forward very quickly in many countries throughout the world. In contrast to several years ago, when privatization was much discussed and the U.S. government was actively promoting the concept of privatization, the rationale for privatization is now widely accepted. Issues now concern the implementation of privatization and the appropriate techniques to use, whether in the wealthier countries of Latin America or the poorest countries of Africa. In this section I briefly review recent privatization developments in each major region of the developing world.

Worldwide Privatization in Dollar Volume (Billions)	*1992*	*1993*
Africa and the Middle East	$1-2	$1-2
Asia	$4-6	$6-7
Eastern Europe and the N.I.S. Eastern Germany All Other	$17 $14 $3	$9 $5 $4
Latin America	$13-20	$7-10
Total Developing World Excluding Eastern Germany	$35-45 $21-31	$23-28 $17-23

Sources: *International Privatization Update* , *Privatisation International* and International Privatization Group estimates.

Latin America has led the developing world in terms of the pace of its privatization, although Central and Eastern Europe and the former Soviet Union have recently begun to implement massive programs. In 1992, transactions in Latin America accounted for about one-third of the developing world's total, up from less than 10% in 1988. Latin American governments see privatization as a quick means of economic reform, specifically, as a means of attracting foreign investment and fostering economic liberalization. Progress in this region has been mixed, as some countries have several years of success behind them while others are only beginning.

The predominant method of privatization in the region is trade sales of enterprises, conducted on a case-by-case basis. In addition, there have been several significant public offerings.

Chile is nearing the end of its privatization cycle, having pioneered in the strategy early in the 1980s. By 1991, it had privatized the financial sector, nearly all the manufacturing sector, and much of its transport and communications. While the state sector in 1973 accounted for 40 per cent of Chile's gross domestic product (with over 375 enterprises), Chile's military rulers distributed to general investors shares in state run companies--mostly in insurance firms and utilities. Other state firms were auctioned off or sold to individual shareholders. As a result of this massive privatization effort, the Chilean government sold 24 state enterprises, between 1985 and 1989, raising $1.7 billion.

Next to Chile, Mexico has been the boldest in the area of privatization in the Latin America. As of mid-1990, the government claimed to have sold, merged or liquidated 750 public enterprises out of a total 1,155. Some 300 firms have been closed outright. Only 250 have been available for sale to private entities.

The Argentine government took in revenues of $7.6 billion from the sale of more than 200 companies in the last three years, according to the official figures published in late December, 1992. Investments in privatized companies are expected to total $36 billion by the year 2000. Excluding the petroleum sector, the new owners invested nearly $8 billion in the last three years. Once the railroad properties are fully disposed of, outflow to state enterprises will amount to only about $200 million.

Nicaragua successfully divested itself of 237 companies from its targeted 350 through the end of 1992. Bolivia and Ecuador have just recently begun their privatization programs, though neither had established specific timetables for privatization and privatized only on a case-by-case basis. Bolivia has announced an innovative program, combining features of trade sales and mass privatization.

The expansion of investment for modernization and the development of local capital markets were significant during 1992. Within the realm of emerging stock markets, Latin America captured 33% of global market capitalization. However, the region did suffer slow growth rates, sagging capital markets and declining trade surpluses at the close of 1992.

Governments in Latin America permit employee participation when conducting the sale of a state-owned company, allowing employees to be the first to make bids on shares to be sold. Venezuela and Panama stipulated in their privatization laws that initial offers of shares were to be extended to the company's employees prior to accepting bids from outside investors. In some cases, preference for share purchase was also extended to the company's suppliers and customers before allowing other investors to make bids. In general, employees were permitted to purchase a minimum of 5% of the company and a maximum of 20%.

The role of foreign investor participation varied within the region, though there existed a desire for increased foreign investment in order to enhance capital market development. Colombia passed resolution 52 to allow full foreign participation, yet most countries have kept foreign participation limited to about 40%.

The future of privatization in Latin America has a positive outlook, particularly with growing support for the program. Privatization in Brazil will be back in full swing once final revisions have been made by the government. Argentina and Mexico will carry on as leaders of privatization in the region, even though both countries plan to complete their programs in the near future.

The nations in Asia have made significant progress toward achieving their privatization goals and are now beginning to privatize larger state-owned enterprises (SOEs) and public utilities. According to *International Privatization Update* (Jan/Feb 1993), annual privatization activity, measured in dollar volume, has increased 70% from its 1991 level. Privatization through public offering is the most common method of privatization in Asia. In addition to domestic offers, Asian countries opened their stock markets to foreign investors as well.

Asian countries are also focusing on infrastructure finance to accommodate rapid economic and social change. The region is particularly focused on expanding its power generation and distribution capacity. There is an increased emphasis on infrastructure privatization as power generation facilities, rail lines, roads, airports, and sea ports are now candidates for private sector involvement. Asian governments have made plans to privatize their large parastatals, but have encountered difficulties in executing their designs. These SOEs, usually government monopolies in sectors such as petrochemicals, air transport, or steel, enjoy a domestic market with few competitors, but the rigors of international competition necessitates their privatization.

Malaysia has already raised $3 billion, and is planning transactions for another 50 firms by 1996. The stock exchange in Kuala Lumpur increased its capitalization and its listings. A large number of state-owned enterprises were sold in industries such as automobile manufacturing and pharmaceuticals for a total of 5 major transactions. Malaysia has also authorized an ambitious privatization program to be implemented over the next six years.

Sri Lanka's privatization initiative yielded positive results as well. Nearly 50 SOEs have been transferred from the government to the private sector. Sri Lanka also had success in its efforts to attract foreign capital as foreign investment increased by 75% in 1992.

Privatization efforts have commenced in China with several high publicity initial public offerings (IPOs) on regional stock exchanges. Additionally, state governments in China were directed to list local agencies suitable for privatization. These are China's first serious steps toward large scale privatization. To date, most private sector involvement has been in the form of joint ventures with foreign partners.

Bangladesh has been putting far greater reliance on the private sector since the late 1970s and has sold state equity in numerous companies in chemical, textile and jute industries. Within two years of privatization, the textile mills in question have been turned around and are making substantial profits compared with heavy losses previously.

Taiwan authorized an enormous $303 billion six-year plan designed to develop the country's infrastructure. The program includes an initiative that will involve the private sector in infrastructure development. The government also conducted studies on the feasibility of privatization in certain sectors, but has not yet initiated the privatization process.

The Philippines has made impressive progress by privatizing several large enterprises and is now nearing completion of the portfolio of state assets held by the Asset Privatization Trust.

Although nations like Pakistan have ambitious plans, the process of privatization in these countries continues to move slowly. Labor concerns and a lack of capital have hindered privatization efforts in that country.

Privatization is new to Thailand and Vietnam and their governments have not developed longstanding commitment to the process. In Thailand, SOEs account for a large portion of

government revenues. Vietnam has recently initiated a privatization program, but until recently officials in that country have been most concerned with attracting capital, in the form of aid and investment, from foreign sources.

Finally, labor issues have continued to play a role in shaping privatization strategy. Employees of SOEs are often concerned about the potential job loss caused by the elimination of redundant positions in privatized firms. The governments of the region have made concerted attempts to address these concerns in their privatization plans. Examples of programs that guarantee worker jobs and/or retraining can be found in Pakistan and Malaysia. Taiwan, the Philippines, and Sri Lanka all of which make extensive use of employee ownership initiatives, such as employee stock ownership programs (ESOPs).

In the years to come, Asian privatization will be funded by regional leaders such as Japan, Hong Kong, Taiwan, and Singapore. These countries will be the leading investors in China, Vietnam, Indonesia, and the Philippines. The political will to continue privatization remains strong, but Asian governments have entered a more difficult stage as they attempt to privatize larger enterprises and infrastructure.

Privatization and private sector development were relatively insignificant in Africa just a few years ago. They are now a prominent part of the economic reform programs of most African countries, very often the mainstays of broader economic reform programs. Adjustment programs, becoming more common in the region, usually stipulate some adherence to private sector development and public sector reform. Few countries seem able to move beyond the planning stages or even sustain successful programs once implemented. Countries in this region have so far approached privatization hesitantly, mostly as a revenue-enhancing measure or to relieve the budget of the strains of debts incurred by state-owned enterprises.

Of all the countries in the region, several have established and maintained successful privatization programs capable of carrying out transactions on a sustained basis. These countries--Côte d'Ivoire, Egypt, Ghana, Zambia, and Nigeria--are continuing programs of moderate success from previous years. Morocco and Egypt have probably been most successful in making the recent transition from the planning stage to implementation.

Morocco has become a regional leader, retaining its strong commitment to privatization and completing the preliminary stages for a number of transactions during the year. With several experimental transactions in the cement and tourism-related sectors behind it, Morocco is now focusing on larger industrial enterprises and the creation of a viable capital market as the foundation of a dynamic private sector.

A number of other Sub-Saharan countries have moved beyond simple commitment, developing the political will and technical capacity to implement privatization. Zambia's development of its privatization program was a year-long process, yielding an ambitious schedule of hundreds of parastatals to be privatized in no less than eleven tranches. Though the recent conclusion of the

first tranche proved the process to be more difficult than originally envisioned, the privatization program remains a central component of Zambia's economic and political reform program.

Elsewhere in the region, progress was not so forthcoming. Kenya's impetus to reform seemed to stall as it resisted critical stabilization measures recommended by the IMF throughout the year. In Nigeria, domestic controversy and political opposition stymied the government's efforts to move ahead with its plans to privatize over 100 large state-owned enterprises, including several important industrial monopolies.

Despite a seemingly strong commitment to the concept of privatization, many of the other Sub-Saharan countries have had difficulty sustaining an active program. Tanzania, for example, initially moved forward politically with privatization but was unable to sustain the effort because of sharp declines in its already weak economy. The Seychelles has maintained a strong public sector and has shown no immediate intention to develop a privatization program even though it is a middle income country with access to capital through its tourist trade.

Political stability is a precursor for the initiation and implementation of a privatization program. Governance issues are particularly prominent in the preparation stage, while meeting training and technical objectives become more important as the process nears the transaction stage. In Africa, a shortage of capital has been the primary problem, slowing the progress to economy-wide transaction implementation, a fact reflected in part by the distribution of countries on either end of the privatization process.

Privatization is often adopted because it is seen as a method to quickly convert to a market economy. Nowhere has this been demonstrated better than in the former socialist countries of Central and Eastern Europe and the former Soviet Union. These newly independent countries have undertaken the most extensive privatization programs in the world, adopting almost every method of privatization available. Both the scope of transaction activity and public participation have been impressive. Hungary, the Czech Republic, and Poland lead this region in terms of implementing and carrying out successful privatization transactions. In each of these countries, the private sector now controls the majority of the economy. Russia has developed an innovative mass privatization program that has divested thousands of enterprises and served as a model for other countries in the region. In many parts of the region, successful programs to auction small businesses have been conducted.

The political process of privatization in this region is daunting, however. With little pre-existing private sector to participate, traditional forms of privatization must draw on foreign and institutional investors to participate, and several countries, most notably Hungary, have done exactly that. But truly innovative privatization programs have developed in most of these countries involving varieties of mass privatization.

Privatization in Eastern and Central Europe and the Newly Independent States (NIS) of the former Soviet Union led the rest of the developing world, both in innovative approach and overall volume of transactions. Regional privatization activity generated approximately $18.0 billion in

transactions during 1992, including nearly $12.0 billion handled by Germany's Treuhandanstalt alone. Programs in Czechoslovakia (now the independent Czech and Slovak Republics), Hungary, and Poland progressed the furthest in 1992, having privatized between one-quarter and one-half of their economies by the end of the year. Other countries, including Russia and some of the Newly Independent States, are rapidly implementing mass privatization programs.

Despite the apparent successes, much remains to be accomplished, as governments struggle to sustain unpopular policies amidst severe economic conditions. Advocating strategies of economic liberalization, most governments have experienced hyperinflation conditions and severe currency devaluations. Without the unprecedented levels of technical and financial assistance through USAID, the World Bank, the IMF, and from most of the G-7 countries, it is highly unlikely that privatization efforts would have been sustained in the region.

<u>What has been the United States' role in the worldwide movement toward privatization?</u>

The United States economy is substantially in the private sector, with state-owned enterprises comprising a small share of national income, relative to other countries. In the United States, privatization debates focus on the more exotic forms of privatization, such as schools and prisons, or on private provision of infrastructure. With the exception of a few very large enterprises--such as the Tennessee Valley Authority, Bonneville Power Administration, and the US Postal Service--there are no candidates for privatization that are widely discussed.

In contrast, the US role in promoting and assisting privatization in other countries has been significant. The US Agency for International Development has played a critical role in providing needed technical assistance to governments around the world in developing privatization programs. This technical assistance has helped to develop the infrastructure needed for privatization programs, promoted better policies and broader marketing of companies, and provided the expertise needed to facilitate informed, confident decision-making by governments in developing countries. This assistance in many countries has made a positive contribution toward speeding and sustaining the privatization process.

<u>What are the opportunities for small business in privatization?</u>

Small businesses are one of the chief beneficiaries of privatization. Small businesses are often among the first enterprises to be privatized, due to the speed and simplicity of the auction method normally used. These auctions empower thousands of new entrepreneurs and give hope to their dreams of owning and expanding a business. It is widely believed that the small-scale auctions will create a new class of owners in developing countries that will provide significant managerial talent, as the economies develop.

A second implication for small businesses is that, as firms are privatized, many larger businesses will begin to look for new suppliers. Particularly in former Communist countries, the distribution and supply channels for large enterprises were controlled internally or provided by other similarly

large enterprises. Increased privatization--and increased reliance on markets--will create many new business opportunities for the small businesses in the economy.

What future directions are developing country privatization programs likely to take?

Within my review of regional privatization activity, I have suggested what the near term continuation of privatization policies is likely to include. Privatization of infrastructure, mass privatization of enterprises, and continued reliance on trade sales and IPOs will be the order of the day for the next several years. Over the longer term, there is a clear need to assist countries to ensure that the privatized enterprises have the opportunity to remain viable and to grow, and to respond to their shareholders. Programs to assist in restructuring newly private enterprises, developing capital markets and financial institutions, raising capital from foreign investors, and developing effective corporate governance will be the major components of that assistance.

Privatization in Chile & Mexico: A Comparison

Testimony by Christopher Whalen
Committee on Small Business
U.S. House of Representatives

April 14, 1994

Mr. Chairman, thank you for asking me to appear before your Committee today. My name is Christopher Whalen and I am a director of The Whalen Company, a Washington based consulting and information services firm. We publish a newsletter on Mexico and are active as consultants with respect to Mexico,1 Chile, Venezuela and other countries in the region.[1]

You have asked me to compare the privatization programs in Chile and Mexico, particularly as it may affect small business. To do this, I propose to look briefly at both financial and legal elements in each country try to draw some conclusions that may be helpful to you and the other member of the committee. I will then discuss the relative advantages and dangers for U.S. small businesses that want to do business in Mexico and Chile.

When comparing the privatization programs seen in Latin America in recent years, I think we should define success to mean that the process has created an environment conducive to the creation of new private businesses, which almost by definition are very often small business enterprises.

Financially speaking, Chile also stands out in comparisons to Mexico and other Latin nations in the way in which it has used foreign capital to build new industries and export sectors. Prior to 1988, only Chile had taken steps to dismantle its core public sector holdings, including 19 commercial banks, most industries and

---

[1] I currently serve as an adviser to the 1994 presidential campaign of Cuauhtemoc Cardenas in Mexico and as a consultant to companies and investors active in Mexico. The opinions expressed here are entirely my own

electric power concerns, airlines, and pension funds.[2] Unlike many of the other nations of the region, Chile's right-wing military government provided a strong impetus to quickly and completely shed all of the functional remnants of the country's experiment with state socialism under Salvador Allende. [3]

Selected Privatizations in Chile

ENTel	Sold to Telefonica of Spain (1986-87)
CTC	Sold to Australian Bond Group and employees (1987-88)
LanChile	Scandinavian Airlines buys 35 percent (1987).
Ladeco	Iberia buys 30 percent and workers 10 percent (1990).
ENDESA	Public offering of energy concern (1986-1989).

Mexico, as well as Venezuela, Argentina and Brazil, have all tended to take a more incremental and thus less complete approach to privatization. In the case of Mexico, the first step was to reorganize the bloated public sector industries during the 1982-1988 period under President Miguel de la Madrid. The second phase was to then sell these state industries to naive foreign investors in the period after 1988. [4] Literally thousands of public sector companies have been sold or liquidated in Mexico since 1988, yet state control remains in areas such as petroleum, electricity, railroads, and airports.

Unlike Chile, Mexico has placed little emphasis on creating new export oriented industries or on fostering private sector activity generally. Instead Mexico has used foreign capital inflows and foreign debt to finance current consumption and subsidize a balance-of-payment deficit. The Salinas government uses confiscatory taxation as a new form of statist control over private industry, particularly the smaller businesses that provided the majority of Mexico's job growth in the mid-1980s. Inspired by the

---

[2] See Ramaturti, Ravi, :"Privatization and the Latin American Debt Problem," University of Miami, North South Center, 1992.
[3] See Whelan, James R., "Allende: Death of a Marxist Dream," 1981, [ISBN 0-87000-503-0].
[4] The Chronology goes something like this: Salinas is "elected" in fraud ridden election in 1988. Brady "debt reduction" Plan emerges in 1989 to help Salinas gain access to new foreign money; and NAFTA is final step, accelerating the amount of money flowing into Mexico to over $50 billion as of year-end 1993.

International Monetary Fund, Mexico's tax policies focus more on collecting revenues than on engendering higher private sector earnings. In Mexico, the Salinas tax regime is known as "fiscal terrorism" by members of the business community and press commentators.

In Chile new capital inflows have moved largely into medium and long-term projects in areas such as mining, agriculture, and industry, helping the country maintain a healthy balance of payments even while importing capital and equipment from abroad. The reason for the relative success of Chile over the Mexican model can be attributed to this preference for productive, long-term investment, but also starts with the most basic factor affecting any business: freedom.

In democratic Chile, property rights are secure and citizens or foreigners have the ability to seek redress in the courts or from their political representatives. Businesses may use the courts to enforce agreements or to compel performance on a contract and, if need be, use a lien or asset seizure to satisfy a debt. Overall, Chile is a nation of laws where property is respected and foreign businesses, especially smaller concerns, can operate with a relatively high degree of confidence and security.

More important, the Chilean economy is relatively free and open, the currency is fairly valued and inflation is stable if not quite in the single digit range. Private citizens control their own savings and retirement accounts, separate from entanglement within government finance as is the case under the bankrupt American Social Security system. This growing cash reserve has provided a huge pool of capital for new investment that has financed a large part of the privatization process. Even with the strong movement of capital into Chile, 1993 was the first year in the past decade that the country ran a trade deficit of $978 million. [5] Indeed, there is so much capital flowing into Chile that the

[5] Chile's current account deficit was $2.1 billion or 5 percent of GDP in 1993. In the first two months of 1994, Chile's trade account, which represents two thirds of GDP, swung back into surplus

the country's private investment managers have for years invested savings in offshore markets.

In authoritarian Mexico, on the other hand, property rights remain uncertain and the courts are dysfunctional at best. The desires of men rather than written laws determine the outcome of business disputes. Business people, Mexican or foreign, have limited access to legal redress and have no ability to compel politicians to be accountable.

The best kept secret in Washington and on Wall Street is that the Salinas economic is a failure. Despite the fact that the peso has slipped 8 percent against the dollar since January, economic growth remains stifled by a strong currency and repressive taxes. Years inflation early in the Salinas *sexenio* has left the peso roughly 30-40 percent overvalued in real terms, depending on whom you ask.

Selected Privatizations in Mexico

Telmex	Bought by Southwest Bell, workers and investors (1990).
Mexicana	Bought by local investors (1989).
Aeromexico	Bought by local investors (1988).
Banamex	Bought by local investor groups (1992).

The Mexican economy grew at a mere 0.4 percent in 1993, the lowest rate in 7 years. Manufacturing actually shrank 5 percent last year and anecdotal evidence suggests worse. My own suspicion is that the Mexican economy has been shrinking in real, inflation adjusted terms for a last 12-18 months.[6] One large industry group in Monterrey reports two firms closed for every new venture begun. Unemployment and business failures are soaring nationally, while the newly privatized banks are experiencing record losses on bad loans. In rural areas, one million additional farmers reportedly are being put off the land annually due to competition from inexpensive imported grain from the U.S. and Canada.

---

[6] See Sosa, Ivan, "En el Desempleo, 25% de la Fuerza Laboral Mexicana, Afirma Fidel," *El Financiero*, January 24, 1994, Pg. 29.

Ross Perot's "great sucking sound" is not the noise of U.S. jobs moving south, but the sound of jobs and small and medium-size companies in Mexico being sacrificed on the altar of "neoliberal" reform. The vast inflow of dollar investment into Mexico, which was created by artificially low interest rates in the U.S. over the past three years, exceeded $50 billion in four years and has created the unemployment, rising crime and violence, and other severe distortions now visible in Mexico.

For example, virtually none of the "capital surplus" flowing into Mexico has been invested in new factories or to create new jobs or exports. Stocks and bonds issued by existing Mexican companies are bought and sold in a casino-style atmosphere reminiscent of the Roaring Twenties. The Salinas government's commitment to "free markets" goes only far enough to let it borrow more money from overseas investors.

Economic dislocation, in turn, is the engine behind growing political unrest. The rebellion in Chiapas, the gangland-style murder of Luis Donaldo Colosio, and literally thousands of kidnappings seen in Mexico in recent years, are all symptoms of a destructive economic malaise driven by low articially interest rates in the U.S. and manifested in the speculative mania which has gripped Mexico and other world financial markets for the past several years.

Roberto Salinas Leon, one of Mexico's leading economists and a strong advocate of free-market principles, recently listed three areas where Mexico and Chile differ with respect to their experiences with privatization. Some of these points have also been attributed to former Chilean Finance Minister Hernan Buchi.

First is the vital issue of transparency. In all of the Chilean privatizations, there has been a relatively high degree of transparency as to the sources and uses of funds. How the money raised was distributed following different sales of state-owned companies in Chile is a matter of public record.

In Mexico, on the other hand, there is no way to determine how much was paid for a former state-run company or who actually made the purchase. Because of the opaque nature of the legal system and the use of nominees and other mechanisms, in Mexico it is virtually impossible to tell who are the beneficial owners of a newly privatized company or where the funds used in a privatization were raised.

Second is the question of participation. In Chile, the privatization of state-owned companies involved the distribution of shares to a large portion of the population. In fact, part of the funding for the privatizations in Chile came from the unique private-sector "social security" savings mechanism that I mentioned before.

As Dr. Salinas Leon said to me earlier this week: "In Chile they created a new ethic of ownership by spreading the proceeds of the privatization widely among the public. The success of Chile is that they embraced the notion of popular capitalism."

In Mexico, on the other hand, the privatizations have involved only a small group of domestic and foreign investors. Former state monopolies in telephones, banking and other sectors have evolved into private cartels. Whereas Chile created a new ethic of ownership and individual investment by distributing shares to the broad population, in Mexico the privatization program has been run by and for the ruling elite, with little or no public accounting for the sources and uses of funds.

In fact, because of the enormous degree of corruption and the lack of accountability present in the Mexican privatization program, some observers refer to the Mexican experience as "PRIvatization," in an allusion to the ruling government party which is known as the PRI. I have had conversations with bankers in New York who say that direct payments have been made to officials of the Salinas government with respect to privatization deals and other state-sector projects.

A third aspect of the dichotomy between Mexico and Chile is the issue of strategy. In Mexico, the government generally started with the smallest state-run companies and worked its way up to the larger firms, arguing that it was best to learn from the smaller firms and perfect the process through trial and error. In Chile, by comparison, the government started with the largest enterprises and worked its way down on the assumption that a good example should be set at the outset and followed throughout.

Let me read you a passage from a book on the subject: "The deep structural transformation which the Chilean economy is undergoing is symbolized on the side of a road just before the city of Rancacagua. Until a short time ago, anyone traveling past there could see the abandoned building which was once a Fiat assembly plant. Nowadays, having been purchased by the Arab group Bin Mahfouz, it has become a modern fruit cold-storage plant, where innovative technology is applied. It stands as a genuine symbol of the death of one company and the rise of another." [7]

The important thing to note from this passage is that the new company is oriented toward shipping fine Chilean fruits to export markets. The fact of the matter is that while such examples of new, export-oriented projects predominate in Chile, in Mexico they are the exception. This is why Chile is the envy of the developing world and Mexico, while highly touted by stock brokers, lobbyists and officials from the State Department, is now faltering after several years of artificial contrived "success."

Let me close my remarks by making some recommendations about small business operating in Chile and Mexico in the post-PRIvatization environment.

Generally speaking, in Chile one needs to take only those precautions that are prudent when doing business anywhere in the world where the rule of law prevails. Chile is an honest, at times regimented society where corruption is the exception and penalties for illicit behavior and back-room deals are severe.

---

[7] Lavin, J., "Chile, A Quiet Revolution," Empresa Editorial Zig-Zag, Santiago, Chile, 1988

If you have good legal representation and local assistance with respect to business practices and the political terrain, any U.S. firm should be able to penetrate the Chilean market and share in the prosperity that its citizens have been able to achieve over the past decade.

In Mexico, on the other hand, the situation with respect to doing business is more problematic. In the public sector, corruption is commonplace and government officials often expect payoffs in connection with contracts and bidding. The key thing to remember: make sure you are paying the right person.

Generally speaking, in Mexico's public sector if you don't pay then you don't play. This means that smaller U.S. companies must compete against large multinationals from Europe and Asia who are ready and able to pay bribes and kickbacks to win a piece of business. Obtaining permits and gaining access to markets is likewise a process in which gratuities must be paid all down the line. [8]

In the Mexican private sector, on the other hand, it is possible to find very honest, reputable people with whom business can be done honestly and without resort to payoffs. More mundane concerns are not absent, as in any foreign market, concerning such things as accounts receivable, background checks and due diligence. As I already mentioned today, collecting bad debts in Mexico is not only difficult but can often be impossible, especially for small businesses that lack the resources and political clout inside Mexico that is wielded by some of the larger multinational concerns.

Let me conclude with an anecdote about a small U.S. company of which I am a director, Arriba Limited of Houston Texas, which has extensive experience in both Chile and Mexico. Arriba has a final, adjudicated judgment from Harris County

---

[8] See Whalen, Christopher, "Free Trade Without Freedom," testimony before the Committee on Banking Finance, and Urban Affairs, September 8, 1993.

Texas against the Mexican Petroleum Workers Union in excess of $450 million . The judgment arose after two defaults by the Union on a delivery of waste oil in the early 1980s. While we at Arriba have been able to seize assets belonging to the Union in the U.S., we cannot enforce the judgment in Mexico. We are currently in the process of seizing assets in Europe and Chile and other parts of the world, but Mexico is closed to us because the court system is almost entirely corrupted. In Chile, however, a final U.S. judgment is treated as a valid claim that can be enforced using the full power of the courts.

Even if Arriba could appear before an impartial tribunal in Mexico, the political influence of the Union and its political allies inside the state petroleum monopoly, Pemex, and the Mexican Government would preclude a positive outcome. The fact is that in any litigation involving any companies, foreign or domestic, in Mexico, both parties hypothetically could all pay all the judges, but the final outcome would still favor the party with the greatest political inflouence.

To summarize, the major difference between the privatization experience in Chile and Mexico is the degree to which the former is a free and open society, and the latter is closed. The relatively high degree of transparency in Chile and the strong commitment to market-based reforms across the entire spectrum of industry has made the Chilean model the envy of the world. In Mexico, however, the privatization process has been only partially completed and remains blocked from total success by the basic, systemic flaws in the Mexican political economy.

78-333 O - 94 (132)

ISBN 0-16-046376-9

90000

9 780160 463761